(49)

No. 92-1384-CSX
Status: GRANTED

Title: Barclays Bank, PLC, Petitioner
v.
Franchise Tax Board of California

Docketed:
February 22, 1993

Court: Court of Appeal of California,
Third Appellate District

Counsel for petitioner: Garvey,Joanne M.

Counsel for respondent: Laddish,Timothy G.

12-8-92, California Ct of Appls den. petn. for rehearing. 2-18-93, Calfornia Supreme Court den. ptn. for review.

Entry	Date	Note	Proceedings and Orders
1	Feb 22 1993	G	Petition for writ of certiorari filed.
2	Feb 22 1993		Appendix of petitioner filed.
4	Mar 1 1993		Order extending time to file response to petition until April 24, 1993.
8	Apr 20 1993		Brief amicus curiae of Reuters Limited filed.
6	Apr 22 1993		Brief amici curiae of Member States of the European Communities, et al. filed.
7	Apr 22 1993		Brief amicus curiae of United Kingdom filed.
10	Apr 22 1993		Brief amici curiae of Nestle Holdings, Inc., et al. filed.
5	Apr 23 1993		Brief amici curiae of Organization for International Investment Inc, et al. filed.
9	Apr 23 1993		Brief amicus curiae of Committee on State Taxation filed.
11	Apr 23 1993		Brief amici curiae of National Foreign Trade Council, Inc., et al. filed.
12	Apr 23 1993		Brief amicus curiae of Confederation of British Industry filed.
13	Apr 23 1993		Brief of respondent Franchise Tax Board in opposition filed.
14	Apr 28 1993		DISTRIBUTED. May 14, 1993
15	Apr 29 1993	X	Reply brief of petitioner filed.
16	May 17 1993	P	The Solicitor General is invited to file a brief in this case expressing the views of the United States.
17	Oct 7 1993		Brief amicus curiae of United States filed.
18	Oct 8 1993		Supplemental brief of respondent filed.
19	Oct 13 1993		REDISTRIBUTED. October 29, 1993 (Page 13)
20	Oct 14 1993	X	Supplemental brief of petitioner filed.
21	Oct 15 1993	D	Motion of Government of the United Kingdom for leave to file a supplemental brief as amicus curiae filed.
22	Oct 15 1993	X	Supplemental brief of petitioner (Second Supplement) filed.
23	Oct 21 1993	D	Motion of Committee on State Taxation, et al. for leave to file supplemental brief as amici curiae filed.
24	Nov 1 1993		Motion of Government of the United Kingdom for leave to file a supplemental brief as amicus curiae DENIED.
25	Nov 1 1993		Motion of Committee on State Taxation, et al. for leave to file supplemental brief as amici curiae DENIED.
26	Nov 1 1993		Petition GRANTED. **
30	Dec 14 1993		Brief amicus curiae of Keidanren (Japan Federation of Economic Organizations) filed.

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Entry	Date	Note	Proceedings and Orders
27	Dec 15 1993		Brief amici curiae of Organization For International Investment Inc, et al. filed.
28	Dec 15 1993		Brief amicus curiae of Council of Netherlands Industrial Federations filed.
29	Dec 15 1993		Brief amici curiae of Federation of German Industries, et al. filed.
31	Dec 15 1993		Joint appendix filed.
		*	Joint Appendix in two volumes.
32	Dec 15 1993		Brief of petitioner Barclays Bank PLC filed.
33	Dec 15 1993		Brief amicus curiae of Committee on State Taxation filed. VIDED.
35	Dec 15 1993		Brief amici curiae of Member States of the European Communities, Belgium, et al. filed.
37	Dec 15 1993		Brief amicus curiae of Japan Tax Association filed.
38	Dec 15 1993		Brief amicus curiae of Reuters Limited filed.
39	Dec 15 1993		Brief amicus curiae of Banque Nationale DeParis filed.
34	Dec 16 1993		Brief amicus curiae of Government of the United Kingdom filed.
36	Dec 16 1993		Brief amici curiae of Washington Legal Foundation, et al. filed.
40	Dec 16 1993		Brief amicus curiae of Confederation of British Industry filed.
41	Dec 21 1993	G	Motion of petitioners for divided argument filed.
52	Jan 4 1994	D	Motion of Government of the United Kingdom for leave to participate in oral argument as amicus curiae, for divided argument and for additional time for oral argument filed.
42	Jan 10 1994		Motion of petitioners for divided argument GRANTED.
43	Jan 14 1994	G	Motion of California Legislature for leave to file a brief as amicus curiae filed.
54	Jan 14 1994	G	Motion of the Solicitor General for leave to participate in oral argument as amicus curiae and for divided argument filed.
44	Jan 19 1994		Brief amicus curiae of United States filed. VIDED.
45	Jan 19 1994		Brief of respondent Franchise Tax Board of California filed.
46	Jan 19 1994		Brief amicus curiae of Citizens for Tax Justice filed. VIDED.
47	Jan 19 1994		Brief amicus curiae of Multistate Tax Commission filed. VIDED.
48	Jan 19 1994		Brief amici curiae of Council of State Governments, et al. filed.
49	Jan 19 1994		Brief amici curiae of North Dakota, et al. filed. VIDED.
50	Jan 19 1994		Brief amici curiae of California Tax Reform Association, et al. filed. VIDED.
51	Jan 19 1994		Brief amici curiae of New Mexico, et al. filed. VIDED.
53	Jan 19 1994		Brief amici curiae of Don Edwards, Howard Berman and Xavier Becerra filed. VIDED.
55	Jan 19 1994		Brief amici curiae of Byron Dorgan, et al. filed. VIDED.
56	Jan 19 1994		Brief amici curiae of Alaska, et al. filed.
57	Feb 2 1994		SET FOR ARGUMENT MONDAY, MARCH 28, 1994. (3RD CASE).
58	Feb 4 1994		CIRCULATED.

Entry	Date	Note	Proceedings and Orders
59	Feb 14 1994		Opposition of petitioner Barclays Bank to motion of California Legislature for leave to file a brief as amicus curiae filed.
60	Feb 16 1994		Opposition of petitioner Colgate Palmolive Co. to motion of California Legislature for leave to file a brief as amicus curiae filed.
61	Feb 22 1994		Motion of California Legislature for leave to file a brief as amicus curiae GRANTED.
62	Feb 22 1994		Motion of the Solicitor General for leave to participate in oral argument as amicus curiae and for divided argument GRANTED.
63	Feb 22 1994		Motion of Government of the United Kingdom for leave to participate in oral argument as amicus curiae, for divided argument and for additional time for oral argument DENIED.
64	Feb 22 1994	X	Reply brief of petitioner Barclays Bank PLC filed.
65	Feb 22 1994		Record filed.
		*	Original proceedings Superior Court, Sacramento. (BARCLAYS - BOX)
66	Feb 25 1994		Record filed.
		*	Original proceedings Court of Appeal of California, Third Appellate District (BARCLAYS - TWO BOXES)

92-1384

No.

In the Supreme Court

OF THE

United States

OCTOBER TERM, 1992

BARCLAYS BANK PLC
Petitioner,

vs.

FRANCHISE TAX BOARD,
An Agency of the State of California
Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE COURT OF APPEAL OF THE STATE OF CALIFORNIA IN AND FOR THE THIRD APPELLATE DISTRICT

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QUESTIONS PRESENTED

1. Whether California's application of worldwide combined reporting to determine the taxable income of domestic corporations with foreign parents, or foreign corporations with either foreign parents or foreign subsidiaries, is unconstitutional under the foreign Commerce Clause.

2. Whether California's application of worldwide combined reporting to determine the taxable income of domestic corporations with foreign parents, or foreign corporations with either foreign parents or foreign subsidiaries, is unconstitutional under the Commerce Clause where such application imposes discriminatory compliance burdens on such entities.

3. Whether California's application of worldwide combined reporting to determine the taxable income of domestic corporations with foreign parents, or foreign corporations with either foreign parents or foreign subsidiaries, intrudes into an inherently federal area and is preempted by the United States Constitution.

4. Whether California's system for compliance with worldwide combined reporting violates the Due Process Clause of the United States Constitution where compliance is not possible without undue cost and the system, to function, depends on discretionary relief provisions without constitutionally sufficient standards to guide application and prevent arbitrary enforcement.

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PETITION FOR A WRIT OF CERTIORARI TO THE COURT OF APPEAL OF THE STATE OF CALIFORNIA IN AND FOR THE THIRD APPELLATE DISTRICT

PETITION FOR WRIT OF CERTIORARI

This petition for a writ of certiorari seeks this Court's review of the judgment of the California Court of Appeal, Third Appellate District, after remand from the California Supreme Court, on a nationally and internationally important matter relating to the limitations under the United States Constitution on the power of the states to apportion and tax the income of domestic corporations with foreign parents, or foreign corporations with either foreign parents or foreign subsidiaries, under worldwide combined reporting.

OPINIONS BELOW

The Statement of Decision of the California Superior Court (Appendix A)[1] is an unreported decision. The first opinion of the Court of Appeal of the State of California in and for the Third Appellate District (App. B) was reported at 232 Cal. App. 3d 1187 (1990) and again at 3 Cal. App. 4th 1034 (1990) to permit tracking of the case pending review by the California Supreme Court.[2] The opinion of the Supreme Court of California (App. C) is reported at 2 Cal. 4th 708 (1992). The opinion of the Court of Appeal on remand, as modified, is reported at 14 Cal. Rptr. 2d 537 (1992)[3] (App. D). The California Supreme Court denied review on February 18, 1993 without opinion (App. E).

LIST OF PARTIES

The parties are as stated in the caption. In the courts below, the plaintiffs and respondents were Barclays Bank International Limited, a United Kingdom corporation, and Barclays Bank of California, a California corporation which was wholly owned by Barclays Bank International Limited. As appears in the Rule 29.1 Statement, Barclays Bank International Limited was merged with Barclays Bank PLC and Barcal was sold to Wells Fargo & Company with the present tax matters and claims for refund being assumed by Barclays Bank PLC.

RULE 29.1 STATEMENT

Pursuant to Rule 29.1 of the Rules of this Court, petitioner states that during the income year 1977, Barclays Bank International Limited ("BBI"), a United Kingdom corporation, was a wholly owned subsidiary of Barclays Bank Limited ("BBL"), also a United Kingdom corporation. During income year 1977, Barclays Bank of California ("Barcal"), a domestic corporation, was a wholly owned subsidiary of BBI. On February 15, 1982, BBL reregistered as a public company under the provisions of the Companies Act 1980 of the United Kingdom and changed its name to Barclays Bank PLC. On January 1, 1985, under the terms of the Barclays Bank Act 1984 of the United Kingdom, the United Kingdom banking business of Barclays Bank PLC was merged with the international and other overseas banking operations of BBI under the name Barclays Bank PLC. The ultimate parent of Barclays Bank PLC is now Barclays PLC, listed on the London Stock Exchange. On February 20, 1988, Barclays Bank PLC sold the stock of Barcal to Wells Fargo & Company. Under the terms of the agreement, Barclays Bank PLC assumed any tax liability at issue herein and retained all claims for refund. Barclays Bank PLC's non-wholly owned subsidiaries are listed in Appendix G to this petition.

[1] All references to the appendices in this petition are denominated "App." followed by the letter to each item and, where necessary, a page reference.

[2] Pursuant to the California Rules of Court, Rule 976(d), the opinion of the Court of Appeal was vacated by the Supreme Court of California's grant of review on February 28, 1991.

[3] The official reporter, 10 Cal. App. 4th 1742, at present has reported only the unmodified opinion.

JURISDICTION

The California Supreme Court's May 11, 1992 opinion (App. C) decided the first question presented in this petition but remanded the cause to the California Court of Appeal for consideration of the remaining federal issues in light of the California Supreme Court's decision. The judgment of the California Court of Appeal, Third Appellate District, after remand from the California Supreme Court, was rendered on November 20, 1992. The California Court of Appeal denied a timely filed petition for rehearing on December 18, 1992. On February 18, 1993, the Supreme Court of California denied a timely filed petition for review. The now final judgment of the Court of Appeal carries with it all federal issues in this cause. *Urie v. Thompson*, 337 U.S. 163, 172-73 (1949); *Louisiana Navigation Co. v. Oyster Comm'n*, 260 U.S. 99, 102 (1912). Jurisdiction of this Court is invoked pursuant to 28 U.S.C. § 1257(a).[4]

[4] *See also* footnote 13, *infra*.

CONSTITUTIONAL AND STATUTORY PROVISIONS INVOLVED

The relevant portions of the following constitutional and statutory provisions are reproduced in Appendix F: Article I, Section 8, Clause 3 of the United States Constitution (the Commerce Clause); Article VI, Clause 2 of the United States Constitution (the Supremacy Clause); Amendment XIV, Section 1 of the United States Constitution (the Due Process Clause); and California Revenue & Taxation Code Sections 25101 and 25137.

STATEMENT

The issues raised by this case — issues specifically reserved by this Court in *Container Corp. of America v. Franchise Tax Board*, 463 U.S. 159 (1983) — concern the powers of a state to tax a domestic corporation with a foreign parent, or a foreign corporation with either a foreign parent or foreign subsidiaries, under worldwide combined reporting. The precise question presented is whether California's application of worldwide combined reporting to Barcal, a domestic corporation with a foreign parent, and to BBI, a foreign corporation with a foreign parent and foreign subsidiaries, is unconstitutional.

California's action already has caused serious national and international repercussions. The United States appeared as amicus curiae in the courts below to assert that this action is "patently unconstitutional."[5]

1. THE BUSINESS OF THE BARCLAYS GROUP.

In 1977 Barcal and BBI, the California taxpayers, were part of the Barclays Group, a United Kingdom banking group of over 220 corporations doing business in some 60 nations.[6] The ultimate

[5]The United States appeared as amicus curiae in the California Superior Court, Court of Appeal and Supreme Court. The brief filed in the California Supreme Court is reproduced at App. H.

[6]BBI and BBL agreed for purposes of the litigation that they were members of a worldwide unitary business for 1977. App. A at 42.

parent, BBL (now Barclays Bank PLC), was one of the United Kingdom clearing banks. Only two of such subsidiaries (Barcal and Barclays Bank of New York) were incorporated in the United States and only one other subsidiary, BBI, also did business in the United States. The Barclays Group conducted over ninety-eight percent (98%) of its business outside the United States. The Barclays Group was and is involved in all phases of international banking, including retail, merchant, and commercial banking, leasing and consumer credit and finance.

BBI was a corporation organized under the laws of England and was domiciled and doing business in the United Kingdom. BBI also did business in over 33 nations and territories outside the United Kingdom including the United States. BBI operated a banking agency in California. BBI itself owned, directly or indirectly, more than fifty percent (50%) of over 70 subsidiary corporations which operated in approximately 34 nations and territories outside the United Kingdom. Barcal, a California banking corporation, was a wholly owned subsidiary of BBI.

2. THE INTERNATIONAL STANDARD FOR DIVISION OF INCOME AMONG NATIONS FOR TAX PURPOSES.

The United States, the United Kingdom and other nations of the world divide the income of multinational enterprises among nations for tax purposes by the arm's length separate accounting method ("the arm's length method"). The arm's length method treats each corporation as "an independent entity dealing at arm's length with its affiliated corporations, and subject to taxation only by the jurisdictions in which it operates and only for the income it realizes on its own books." *Container*, 463 U.S. at 185. Where a corporation crosses national boundaries, the host (non-domiciliary) country taxes that corporation only on the profits earned in the host country and as if those profits were earned by a separate enterprise.

The United States has been a leader in establishing the arm's length method as the international standard. Both the United States and its trading partners use this standard in all bilateral tax treaties and in their internal tax laws. The standard is "universally

used and favored" by the nations of the world both "as an ideal and as a working methodology." App. A at 20-21. The arm's length standard is the international practice. *Container*, 463 U.S. at 184.

California uses a different and incompatible method to divide the income of a multinational enterprise for tax purposes — worldwide combined reporting. This method aggregates the income of all entities which form a part of the unitary business wherever they do business and determines California's share of this aggregate income by a formula, generally the average of the property, payroll and sales within and without California.

The income allocated to a tax jurisdiction under the arm's length method can and does differ substantially from the income apportioned to that jurisdiction under worldwide combined reporting. There is no way to reconcile these differences.

California worldwide combined reporting requires worldwide tax information for all members of the unitary group, not just for taxpayers. Foreign multinational enterprises incur greater costs to comply with California's reporting requirements than do domestic multinational enterprises and those domestic enterprises doing business only in the United States. While domestic enterprises may keep most of their records in accord with United States financial and tax accounting principles, foreign enterprises generally have no reason to collect worldwide information in that form except to comply with the California tax system. The international standard does not require the reporting of such information. Such foreign enterprises incur significant costs in obtaining the necessary information and transforming it into California tax information. App. D at 9-10.

Only a handful of states of the United States have ever used worldwide combined reporting. No *nation* uses worldwide combined reporting.

3. THE IMPACT OF CALIFORNIA'S APPLICATION OF WORLDWIDE COMBINED REPORTING TO FOREIGN OWNED MULTINATIONALS.

In the early 1970's respondent first extended worldwide combined reporting to foreign owned multinationals. The extension of this conflicting method into the international arena brought immediate complaints from both foreign business and foreign governments. Foreign governments bombarded the United States government with formal and informal diplomatic protests about worldwide combined reporting as applied to foreign multinationals. These included diplomatic notes from virtually every developed country in the world, protestations from heads of nations including Prime Minister Thatcher of the United Kingdom, Prime Minister Nakasone of Japan, and Prime Minister Trudeau of Canada directly to the President, delay in treaty negotiations by the Netherlands and West Germany, and strong representations from the French, Danish, Italian and German governments. The Canadian and French tax treaty negotiators insisted on an exchange of notes which called attention to their concerns and which obligated the United States to reopen discussions with each country if an acceptable solution could be devised. Foreign governments even attemped unprecedented direct persuasion at the state level.

Finally, in 1985, after years of diplomatic effort, the United Kingdom enacted retaliatory legislation which would deny certain treaty benefits to United States corporations operating in unitary states. The legislation had a chilling effect on the willingness of United Kingdom subsidiaries of such corporations to repatriate dividends.

The Federal Executive has steadfastly promoted and adhered to the use of arm's length separate entity accounting for the division of international income and has opposed the use of worldwide combined reporting through all administrations confronted with this issue. Initially, the United States added Article 9(4) to the tax treaty then being negotiated with the United

Kingdom.[7] Article 9(4) would have required states to use the arm's length method when taxing affiliates of United Kingdom companies. Although a reservation which would remove Article 9(4) from the Treaty was defeated in both the Senate Foreign Relations Committee and the full Senate, the majority vote of the Senate for the Treaty including Article 9(4) fell five votes short of the two-thirds majority necessary for ratification. The Treaty was resurrected after parliamentary maneuvering in which the reservation was added without a separate vote, and the Treaty, with the reservation, was ratified by the Senate.[8] The United Kingdom House of Commons ratified the Treaty only after strong assurances from the United States that the matter of worldwide combined reporting would be resolved. The United States has continued with efforts at resolution. The appearance of the United States as amicus curiae in all three California courts below in support of BBI and Barcal is a part of such efforts.

Congress has enacted no legislation dealing with this issue. Bills concerning unitary taxation have been introduced, but there has never been a vote in a congressional committee or in either house of Congress on such a bill. None of the bills has dealt solely with worldwide combined reporting as applied to foreign multinational enterprises.

4. THE ASSESSMENTS.

Respondent California Franchise Tax Board audited the California tax returns of BBI and Barcal for 1977 and determined that BBI and Barcal were part of a worldwide unitary business conducted by the members of the Barclays Group. Respondent assessed additional taxes of $4,076 to BBI and $254,699 to Barcal, subsequently reduced during the administrative process to $1,678 and $152,420, respectively. BBI and Barcal protested the tax on the basis, inter alia, that the correct method upon which to compute the tax was the arm's length method. App. A at 39-40.

[7]The United States/United Kingdom Income Tax Convention is hereafter referred to as the US/UK Treaty or Treaty.

[8]The reservation was included in the Third Protocol to the Treaty which also contained other changes.

BBI and Barcal paid the additional assessed taxes and filed suit for refund, challenging the constitutionality of the application of worldwide combined reporting to foreign owned multinational groups.

5. THE PROCEEDINGS BELOW.

A. How the Federal Questions Were Raised and Passed On Below.

In their complaints and briefs in the California Superior Court, and in their briefs in the California Court of Appeal and in the California Supreme Court, BBI and Barcal contended that the foreign Commerce and Due Process Clauses of the United States Constitution precluded the application of worldwide combined reporting to taxpayers that are members of a foreign owned and controlled unitary group. These courts explicitly noted and ruled on these constitutional contentions.

B. The Decisions Below.

(i) California Superior Court and Court of Appeal (First Opinion).

The California Superior Court found, and the California Court of Appeal affirmed, on the basis of substantial evidence,[9] that respondent's application of worldwide combined reporting to foreign owned multinational groups violated the foreign Commerce Clause because it "impair[ed] federal uniformity in an area where federal uniformity is essential" and "prevent[ed] the Federal Government from 'speaking with one voice when regulating commercial relations with foreign governments.'" *Japan Line, Ltd. v. County of Los Angeles*, 441 U.S. 434, 448, 451 (1979) (hereafter the "one voice" test).

Both courts rejected the contentions of respondent that five factors showed a congressional policy "to permit the states to tax

[9]Although there are some stipulations, App. A at 36 and 70, the case was tried on a contested record. The Statement of Decision of the Superior Court (App. A) explains the factual and legal basis for its decision as to each of the controverted issues at trial. Cal. Civ. Proc. Code § 632.

as they please" by "negative acquiescence" without congressional legislation.[10] In light of the distinctions between this case and *Container* and the radical differences between the arm's length international standard and worldwide combined reporting, both courts found that a direct adverse impact on foreign affairs from the use of worldwide combined reporting was "inevitable."[11]

The Court of Appeal also found a clear and thoroughly grounded policy of the Executive to require the use of the arm's length method to divide income of foreign multinational enterprises. The Court of Appeal further found that, in the face of congressional inertia and inaction and in an area where the Executive has traditionally been given great deference, this policy constituted a "clear federal directive."

Regarding the discrimination issue, the Superior Court found de facto discrimination amounting to economic protectionism where domestic competitive enterprises did not have the compliance burden which worldwide combined reporting placed on foreign based multinational taxpayers. App. A at 26. The Court of Appeal acknowledged this legal analysis was based on substantial evidence, and mentioned that foreign anger was even more understandable "in light of the critical role the United States has played in attempting to construct a coherent and nondiscriminatory tax policy for all nations" based on separate accounting. App. B. at 26.

The Superior Court also ruled that the due process clauses of the California and United States Constitutions were violated.

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[10]The factors were: no coverage of state taxes in United States treaties or the United States Model Income Tax Convention, except in nondiscrimination clauses; failure of the Senate to ratify the US/UK Tax Treaty with Article 9(4); failure of Congress to enact legislation restricting state taxes; reservations to the OECD and UN Model Income Tax Conventions; and no coverage of state taxes in treaties of friendship, commerce, and navigation.

[11]The Court of Appeal affirmed the holding of the Superior Court that, even with the "definite risk of, as well as actual double taxation" in this case, worldwide combined reporting in this context did not fail the first additional test of *Japan Line* (double taxation).

(ii) California Supreme Court.

In reversing the decision of the Court of Appeal, the California Supreme Court recognized that it was "presented with a question left open in *Container*, (*supra*, 463 U.S. at p. 189, fns. 26 & 32)," App. C at 3, but rejected analysis under the tests this Court set forth in *Container* and *Japan Line*. Rather, the California court declared that *Wardair Canada v. Florida Dep't of Revenue*, 477 U.S. 1 (1986), had "reoriented" the dormant Commerce Clause and had reduced the scope for dormant Commerce Clause analysis so as to make such analysis "particularly inappropriate" in this case. App. C at 19. Instead, "*Wardair* supplants what the court has termed the 'quagmire' of dormant commerce clause analysis . . . with a heightened judicial attentiveness to expressions of congressional foreign commerce policy." App. C at 21. From this perspective, the court "abstracted" this Court's analysis of the "textual materials" in *Wardair* "into a kind of protocol for identifying those kinds of governmental silences that give rise to 'negative implications' supporting an inference of federal acquiescence in the state tax under challenge." App. C at 23.

The California court constructed its own test to determine whether a state tax violates the foreign Commerce Clause: whether in the absence of legislation, Congress' "inaction" constituted a "pattern of congressional action" which "evidences both an awareness of [the] issue and a refusal to adopt the remedy urged upon it." App. C at 38. The court took the same five items which the lower courts had rejected as evidences of congressional policy (*see* footnote 10, *supra*) and under its new test treated them as "those kinds of governmental silences . . . [implying] federal acquiescence in the state tax under challenge." App. C at 23. The court never addressed the fact that this Court had considered the most important of these factors in *Container* (the treaties, Article 9(4), no congressional legislation) and found neither explicit action nor congressional policy.

Because the "*Wardair* methodology interdict[ed] judicial resort to executive branch opinions as to the international commercial effect of a challenged state taxation practice . . . ." App. C at

21, the California court rejected the views of the United States,[12] appearing as amicus curiae, that California's use of worldwide combined reporting interfered with the "Federal Executive's conduct of foreign affairs." App. C at 37 n.22.

Thus, the court did not consider the findings below of burden on commerce or the foreign policy implications in the application of worldwide combined reporting, including retaliation and threats of retaliation, but concluded that it was "adher[ing]" to this Court's "central meaning" in *Wardair* in holding that Congress' "refusal to legislate restrictions on state use of worldwide [combined reporting]" was not silence which triggered dormant Commerce Clause analysis. App. C at 38.

Noting that the Court of Appeal did not appear to have passed directly on the discriminatory effect of compliance burdens on the Commerce Clause and had explicitly declined to decide the due process issue, the court remanded that issue to the Court of Appeal for further proceedings.[13]

(iii) Court of Appeal (Second Opinion).

On remand the Court of Appeal agreed that foreign based corporate groups incurred greater and significant administrative costs to comply with the California system than did their domestic counterparts. However, the court concluded that the burdens were not constitutionally discriminatory because foreign and domestic corporations faced the same tax rate and had to furnish the same information.[14]

[12]The California court concluded that the "clear federal directive" test in *Container* was not part of the dormant Commerce Clause analysis, but served only to determine whether Congress had acted to preempt an otherwise valid state tax.

[13]While such remand was pending on these remaining federal issues, petitioner sought review by this Court of the federal issue decided by the California Supreme Court. 61 U.S.L.W. 3112 (Aug. 3, 1992) (92-212). Respondent opposed the petition chiefly on the ground that the decision of the California Supreme Court was not a final decision of the highest state court under 28 U.S.C. § 1257 because of the remand of the cause to the Court of Appeal for decision on the remaining federal issues. This Court denied the petition on October 5, 1992. ____ U.S. ____, 113 S. Ct. 202 (1992). The now final judgment of the Court of Appeal carries with it all federal questions in this cause, including those decided by the California Supreme Court. *Urie v. Thompson*, 337 U.S. at 172-73; *Louisiana Navigation*, 260 U.S. at 102.

The Court of Appeal further determined that, in the context of a non-arbitrary application, Regulation 25137-6 did not result in unreasonable, undue or arbitrary costs of compliance and that the Regulation could be construed to contain constitutionally adequate standards to guide application of respondent's discretion to grant relief from the mandatory provisions of the Regulation.

REASONS FOR TAKING THE CASE

This Court in *Container* specifically reserved the question which this case squarely presents: the "constitutionality of combined apportionment with respect to state taxation of domestic corporations with foreign parents or foreign corporations with either foreign parents or foreign subsidiaries." 463 U.S. at 189 n.26. Nevertheless, the California Supreme Court, perceiving a "diminution in the reach of dormant foreign commerce clause analysis," App. C at 4, held the very analysis used by this Court in *Container* inapplicable to resolve the question reserved. The California court fashioned a new test in Commerce Clause jurisprudence, permitting a court to disregard "sensitive matters of foreign relations and national sovereignty," *Japan Line*, 441 U.S. at 456, and to search instead for "those kinds of governmental silences that give rise to 'negative implications' supporting an inference of federal acquiescence in the state tax under challenge." App. C at 23. The California court's perception and new approach are inconsistent with holdings of this Court on the sweep and the application of the dormant foreign Commerce Clause. *See Japan Line*, 441 U.S. 434; *Container*, 463 U.S. 159; *Kraft Gen. Foods, Inc. v. Iowa Dep't of Rev. and Finance*, ____ U.S.____, 112 S. Ct. 2365 (1992). They are also irreconcilable with the decisions of this Court on the need for explicit congres-

[14]The court did not address the finding by the Superior Court that only a foreign multinational was put to the choice of foregoing tax benefits or spending inordinate sums to file properly. App. A at 28.

sional action to remove state laws which burden commerce from the reach of the Commerce Clause. *See Wyoming v. Oklahoma*, ____U.S.____, 112 S. Ct. 789 (1992); *Maine v. Taylor*, 477 U.S. 131 (1986); *South-Central Timber Dev., Inc. v. Wunnicke*, 467 U.S. 82 (1984); *Sporhase v. Nebraska ex rel. Douglas*, 458 U.S. 941 (1982).

The limitation on a state's right to burden commerce is an important and recurring issue before this Court and a number of cases and administrative proceedings in California are dependent on the outcome of this case. *See* App. I. The decisions below, if left undisturbed, will stimulate aggressive unconstitutional taxation not just by California but by other states.

The issues presented here are of paramount national importance. The application of this tax method to foreign owned multinational businesses has already led to enactment of retaliatory legislation by the United Kingdom, threats of retaliation by other nations, and strong and continuing protests by all of the major trading partners of the United States. In its appearance as amicus curiae in all three California courts below, the United States has attested that the use of worldwide combined reporting in these circumstances is "an egregious interference with the Federal Executive's conduct of foreign affairs and is . . . patently unconstitutional." *See* App. H at 25 n.13. The administrative burdens of worldwide combined reporting, arising because the system is incompatible with accepted international practice, exacerbate foreign objections and also raise serious questions of improper discrimination in favor of domestic commerce.

The decisions below erode United States foreign economic policy by spreading confusion as to how the policy is formulated, confusion as to who speaks for the United States, and even confusion as to what that policy actually is.

This Court's review of this case is necessary to resolve the conflicts and confusion which the decisions below have created.

1. CALIFORNIA WORLDWIDE COMBINED REPORTING IS UNCONSTITUTIONAL UNDER THE FOREIGN COMMERCE CLAUSE. THE DECISIONS BELOW REWRITE ESTABLISHED FOREIGN COMMERCE CLAUSE JURISPRUDENCE AND ARE INCONSISTENT AND INCOMPATIBLE WITH THIS COURT'S DECISIONS.

The oft-recurring question of whether state taxes may permissibly burden commerce[15] takes on a different dimension when the commerce is foreign.

This Court has recognized that "the constitutional prohibition against state taxation of foreign commerce is broader than the protection afforded to interstate commerce." *Kraft*, 112 S. Ct. at 2370 (citing *Japan Line*, 441 U.S. at 445-46). Foreign commerce merits broader protection because "matters of concern to the entire Nation are implicated. [*Japan Line*, 441 U.S.] at 448-451." *Kraft*, 112 S. Ct. at 2370. Discriminatory treatment of foreign commerce carries with it "the potential for international retaliation" that will concern and "harm the Nation as a whole," not just the offending state.[16]

With these concerns in mind this Court twice reserved the issue of the constitutionality of this very taxing method in *Container*, 463 U.S. at 189 n.26 and 195 n.32, when applied to foreign owned taxpayers. This case squarely presents that reserved question. The California Supreme Court, however, perceived a "diminished reach" in foreign Commerce Clause analysis subsequent to *Container*. That court's perception rested solely on its reading of this Court's *Wardair* opinion as supplanting this Court's traditional analysis. The California court ignored not only the analyti-

[15] *See, e.g., Wyoming v. Oklahoma*, 112 S. Ct. 789; *Kraft*, 112 S. Ct. 2365; *Container*, 463 U.S. 159; *Japan Line*, 441 U.S. 434.

[16] The same policies underlie the import-export clause. *See Michelin Tire Corp. v. Wages*, 423 U.S. 276 (1976) and *Japan Line*, 441 U.S. 434. The broader protection accorded to foreign commerce also requires stricter scrutiny in considering whether Congress has acted to permit such a burden. *See South-Central Timber*, 467 U.S. 82.

cal framework of *Container* and *Japan Line*, but also this Court's very specific requirements of affirmative permission by Congress for a state to burden commerce.

This Court has demonstrated in two decisions subsequent to both *Container* and *Wardair*, i.e., *Kraft* and *Wyoming v. Oklahoma*, that it has not abandoned either its great sensitivity in matters of foreign commerce or its requirement that Congress act explicitly to remove a state enactment from the reach of the dormant Commerce Clause. Thus the decision below remains inconsistent and incompatible with prior and subsequent decisions of this Court.

A. This Court Has Established Criteria for Determining the Constitutionality of State Taxes Under the Foreign Commerce Clause; the California Court Disregarded These Criteria.

This Court has formulated a four part test to determine if a state tax satisfies basic Commerce Clause requirements: (1) the tax must be applied to an activity with a substantial nexus with the taxing state; (2) the tax must be fairly apportioned; (3) the tax must not discriminate against interstate commerce; and (4) the tax must be fairly related to the services provided by the taxing state. *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274, 279 (1977). Recognizing and stressing the need for uniformity in dealing with other nations when foreign commerce is implicated, this Court in *Japan Line* added two additional tests to the basic four part test:

- whether the tax, notwithstanding apportionment, created a substantial risk of multiple taxation; and
- whether the tax impaired federal uniformity in an area where federal uniformity is essential and prevented the Nation from speaking with one voice when regulating foreign commerce.

Japan Line, 441 U.S. at 451. With respect to multiple taxation, this Court pointed out that "even a slight overlapping of tax — a problem that might be deemed *de minimis* in a domestic context — assumes importance when sensitive matters of foreign relations and national sovereignty are concerned." *Japan Line*, 441 U.S. at

456. A tax could prevent the Nation from speaking with one voice and frustrate achievement of federal uniformity by leading to international disputes over reconciling apportionment formulae, by creating asymmetry in the international tax structure leading to retaliation which causes harm to the Nation as a whole, not just to the state, and by increasing the potential for varying degrees of multiple taxation should other states follow the taxing state. *Japan Line*, 441 U.S. at 450-51.

In *Container*, involving the same California taxation method at issue here but applied to a domestic owned multinational group, this Court reaffirmed the two additional *Japan Line* tests, but found constitutionally significant that double taxation was not an inevitable result of the California taxing scheme and that the tax fell not on foreign owned but on domestic owned corporations. Elaborating on the "one voice" inquiry, this Court stated that a state tax at variance with federal policy would fail the one voice standard if "it *either* implicates foreign policy issues which must be left to the Federal Government *or* violates a clear federal directive." *Container*, 463 U.S. at 194. The most obvious foreign policy implication of a state tax was the "threat it might pose of offending our foreign trading partners and leading them to retaliate against the Nation as a whole." *Id.* "In the absence of explicit action by Congress", *id.*, to determine when foreign nations would be offended and to decide how to balance the risk of retaliation against the sovereign right of the United States to let the states tax as they please, this Court developed "objective standards" reflecting general observations about the imperatives of international trade and foreign relations. When applied in the factual context of *Container*, these factors weighed against the conclusion that the California tax might justifiably lead to foreign retaliation: the tax did not create automatic asymmetry in international taxation; the tax fell not on a foreign entity but on a domestic corporation;[17] and, even if foreign nations had a legitimate interest in reducing tax burdens of domestic corporations, the amount of

[17] This Court also reserved the question of whether its analysis as to the importance of the incidence of the tax might be different if the taxpayer were a domestic subsidiary of a foreign corporation. *Container*, 463 U.S. at 195 n.32.

tax paid by the domestic taxpayer was more a function of the tax rate than the allocation method.[18]

1. Under This Court's Criteria, Worldwide Combined Reporting Applied to Foreign Owned Taxpayers Is Unconstitutional.

Tested by the standards of *Japan Line* and *Container*, worldwide combined reporting applied to members of a foreign owned multinational group, as here, is unconstitutional. Worldwide combined reporting clearly implicates foreign policy issues which must be left to the federal government and prevents the Nation from speaking with one voice.[19] This Court need not speculate as to foreign offense: in this case there is actual retaliation as well as threats of retaliation. There is automatic asymmetry in international taxation as United States corporations are not subjected to worldwide combined reporting by any nation. The California tax falls on a foreign corporation as well as on the domestic subsidiary of a foreign corporation. The amount of tax paid is a function of the allocation method, not the tax rate. Finally, the United States has appeared as amicus curiae in all three California courts in this case.

2. The Court Below Ignored the Criteria.

The California Supreme Court ignored this Court's dormant Commerce Clause analysis on the basis that *Wardair* had "supplanted" such analysis, when Congress had not acted, with a search for congressional policy evidenced by inaction. Thus, the court never determined whether worldwide combined reporting implicated foreign policy issues under the standards set forth in *Container* and *Japan Line*. The California Supreme Court further held that the "clear federal directive" prong of *Container* was not a dormant Commerce Clause test but applied only to invalidate otherwise valid state taxes. It thus avoided the question of whether worldwide combined reporting in these circumstances was fatally inconsistent with federal policy, the more relaxed "species of preemption" standard adopted by this Court in *Container*, 463 U.S. at 194. It also avoided any consideration of the role of the Executive in formulating federal policy on the ground that only Congress played any role in creating such policy.

[18]This Court also noted the absence of a brief by the Executive branch. Chief Justice Rehnquist notes in his dissent in *Kraft* that the domestic nature of the petitioner and the absence of a United States amicus brief were the distinctions between *Container* and *Japan Line*. *Kraft*, 112 S. Ct. at 2372.

[19]Petitioner contends that worldwide combined reporting applied to taxpayers which are members of a foreign owned multinational group also violates the first additional test, enhanced risk of or actual double taxation. Whether the *Container* requirement of "inevitability" would apply in the circumstances of a taxpayer which is a member of foreign owned multinational business has not been decided and should also be resolved by this Court.

This Court should affirm that dormant Commerce Clause analysis remains applicable and appropriate, decide the reserved question in *Container*, and give guidance on the scope and application of the "clear federal directive" test.

B. The Decision of the California Supreme Court Contradicts the Conclusions of This Court in *Container*.

This Court in *Container* held that failure of treaties to cover subnational taxes or to restrict states to the arm's length method, failure of the Senate to pass the US/UK Treaty with a provision which would have restricted state use of a non-arm's length method, and failure of Congress to enact legislation restricting state taxation did not constitute "specific indications of congressional intent." *Container*, 463 U.S. at 196. Nevertheless, the California court relied on these same items as evidences of congressional "acquiescence" amounting to ratification of the states' use of worldwide combined reporting. App. C at 34. If such items now evidence a congressional policy sufficient to remove this case from the dormant Commerce Clause, why did this Court bother with its analysis in *Container*, grounded as it is on "the absence of explicit action by Congress" and no "specific indications of congressional intent." *Container*, 463 U.S. at 194, 196. This Court should resolve this conflict.

C. The Decision Below Is Inconsistent with This Court's *Wardair* Decision.

This Court's *Wardair* decision is factually and legally inconsistent with the California court's use of that decision to overturn this Court's dormant Commerce Clause jurisprudence. *Wardair* concerned a state sales tax on a discrete transaction (purchase of fuel in Florida) occurring only within one national jurisdiction and including neither actual nor possible international multiple taxation. In *Wardair*, this Court strongly reaffirmed the policies of the dormant Commerce Clause including the greater need for uniformity in areas of foreign commerce, but determined that the federal policy urged by the petitioner, reciprocal tax exemptions for aircraft, did not exist. On the contrary, "in the context of this case," the evidence demonstrated that the federal government had "affirmatively acted, rather than remained silent, with respect to the power of the state to tax aviation fuel." *Wardair*, 477 U.S. at 9. Congressional action constituting law came from the Chicago Convention, a treaty entered into by the United States and 156 other nations, which by its terms precluded the imposition of local taxes on fuel in certain circumstances but did not prohibit the taxation of fuel in the circumstances before the Court. This text demonstrated:

> the international community's awareness of the problem of state and local taxation of international air travel, specifically aviation fuel, and represent[ed] a decision by the parties to that Convention to address the problem by curtailing and limiting only some of the localities' power to tax, while implicitly preserving other aspects of that authority.

Wardair, 477 U.S. at 10. Subsequent treaties, including the United States/Canadian Treaty, dealt only with national taxes, leading to the inference that Congress had "negatively acquiesced" in the Florida tax.[20] This Court explicitly said that it was not addressing — and the opinion should not be understood as addressing — whether, in the absence of these international

[20]The Canadian provinces also were applying a tax similar to that imposed by Florida, an indication that there was no uniform policy against such taxes and thus no international consensus.

agreements, the foreign Commerce Clause would invalidate Florida's tax. *Wardair*, 477 U.S. at 13. Thus, this Court proceeded in *Wardair* against an extensive background of enacted congressional legislation — the Federal Aviation Act domestically and the Chicago Convention internationally — both of which dealt with state sales taxes and the latter with state sales taxes on aviation fuel.

In contrast, this case involves worldwide activities in a myriad of nations, conflict with the established international standard for the division of income among nations, and actual and enhanced risk of multiple taxation. In this case there is no seminal statute or other enactment which addresses the specific problem and certainly no international agreement on the California court's solution, *i.e.* "let the states tax as they please."[21] On the contrary, there is vehement and unrelenting international opposition, an opposition joined by the United States Executive. The California court even creates its own test for its "reoriented analysis", congressional "refusal" to act while "aware" of the problem, a test which does not appear in *Wardair* — or for that matter in any of this Court's decisions. This Court's *Kraft* and *Wyoming v. Oklahoma* decisions, subsequent to *Wardair*, establish that *Wardair* represents neither the change in course nor the retrenchment claimed by the California court.

D. The Ruling of the California Court Is Irreconcilable with This Court's Standards for Determining Whether Congress Has Acted To Permit a State To Burden Commerce.

This Court has consistently held that, to exempt a state tax or other regulation which burdens commerce from scrutiny, "Con-

[21]Other than Article 9(4) of the US/UK Treaty, none of the items which the court below used as evidence of congressional awareness and refusal to act even deals with worldwide combined reporting applied to foreign multinational groups. Under the California court's approach, the stalemate created by the minority in the Senate over Article 9(4) becomes an explicit "refusal" to act evidencing Congress' exercise of its "power . . . [t]o regulate Commerce with foreign Nations . . . ." U.S. Const. art. I, § 8, cl. 3.

gress must manifest its unambiguous intent before a federal statute will be read to permit or approve of such a violation of the Commerce Clause. . . ." *Wyoming v. Oklahoma*, 112 S. Ct. at 802. *See also Maine v. Taylor*, 477 U.S. at 139; *South-Central Timber*, 467 U.S. at 91; *Sporhase*, 458 U.S. 941. This Court, in *South-Central Timber*, has further stated that the need for "affirmative approval" of the state statute or regulation is "heightened" when the statute has "substantial ramifications beyond the Nation's borders." 467 U.S. at 92 n.7.[22]

In fact, the "burden [is on the state to] demonstrat[e] a clear and unambiguous intent on behalf of Congress to permit the discrimination against interstate [and foreign] commerce. . . ." *Wyoming v. Oklahoma*, 112 S. Ct. at 802.

This Court has held that such intent was not demonstrated by reservation to the states of the regulation of local utility rates in the Federal Power Act (*Wyoming v. Oklahoma*), consistency of the state regulation with federal legislation (*South-Central Timber*), deferral by Congress to state law in thirty seven statutes (*Sporhase*), or approval by Congress of several interstate water compacts (*id.*). The congressional enactment must be "an affirmative grant of power to the states to burden . . . commerce 'in a manner which would otherwise not be permissible.' *Southern Pacific Co. v. Arizona ex rel. Sullivan*, [325 U.S. 761,] 769." *New England Power Co. v. New Hampshire*, 455 U.S. 331, 341 (1982). These cases presuppose some federal enactment which demonstrates such affirmation. Here there is no such enactment.

The California Supreme Court's approach eliminates the threshold inquiry of burden on commerce and the evidentiary burden on the state to show the "clear and unambiguous intent" of Congress to permit a violation of the Commerce Clause. Rather, the California court would assume a tax valid unless Congress says "no."

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[22]The reason that "congressional authorization not be lightly implied" is the need for a consistent and coherent foreign policy which is the exclusive responsibility of the federal government. *South-Central Timber*, 467 U.S. at 92 n.7.

The decision below cannot be reconciled with the decisions of this Court on removal of state action from Commerce Clause scrutiny. The decision is an invitation to state taxation unrestrained by constitutional limitations.

2. THE DECISIONS BELOW UNDERMINE ESSENTIAL CONSTITUTIONAL RESTRAINTS ON STATE POWER TO INTERFERE IN THE CONDUCT OF FOREIGN POLICY, AND, IF LEFT UNDISTURBED, THREATEN SERIOUS HARM TO THE NATION.

The decisions below have implications far beyond the question of constitutionality of worldwide combined reporting as applied herein. The California court proceeds on the assumption that *Wardair* presages a diminution in the reach of the dormant foreign Commerce Clause.[23] Although it recognized that foreign governments objected strenuously to the practice of worldwide combined reporting and that "executive branch officials charged with conducting American foreign commercial policy agree[d] with them," App. C at 37 n.21, the California court used the alleged diminution as its predicate for ignoring both the United States and the foreign governments. Given the importance of foreign Commerce Clause jurisprudence, which concerns "sensitive matters of foreign relations and national sovereignty," *Japan Line*, 441 U.S. at 456, this Court should clarify that there is no such diminution.

The California court's substitute test, if left to stand, would lead to serious harm to the Nation. A recurring theme in this Court's decisions on foreign commerce issues is concern over harm to the nation as a whole from state actions which may lead to retaliation. *Japan Line*, 441 U.S. 434; *Container*, 463 U.S. 159; *Kraft*, 112 S. Ct. 2365; *Chy Lung v. Freeman*, 92 U.S. 275 (1875). These decisions recognize that all nations have a proper concern for the well being of their nationals, that nations do not take these concerns lightly, that response is a national, not a state, responsibility and that states have no role in the process. *Hines v.*

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[23]The California court refers to this Court's "recent foreign Commerce Clause jurisprudence" but relies only upon *Wardair*.

Davidowitz, 312 U.S. 52 (1941); *Zschernig v. Miller*, 389 U.S. 429 (1968); *Japan Line*, 441 U.S. 434.

The decision below, however, trivializes nation-to-nation initiatives to resolve conflicts, including such efforts as those in this case to have the states voluntarily cease use of the apportionment method.[24] Patience by nations is viewed by the California court as evidence of congressional acquiescence. If any test is destined to lead to retaliation by foreign governments, it is the California court's new test.

The "one voice" test proceeds from the strong presumption of the need for federal uniformity in the area of foreign commerce. *Japan Line*, 441 U.S. 434; *Wardair*, 477 U.S. 1. The decision of the court below sees no need for uniformity. Rather it invites state interference in foreign affairs unless Congress curbs the state. The California court would silence the Executive[25] and in the silence of Congress permit a cacophony of state voices. Who can tell our foreign trading partners what the policy of the United States is? Can our foreign trading partners rely upon the responses of the Executive? Is this not exactly the situation which will lead to retaliation and harm to the nation as whole?

The issue is even more serious since it is the United States that has been the leader in establishing the international standard. The standard forwards the long established and overarching United States foreign economic policy to open markets and remove barriers to trade. The standard provides a framework for management of conflict and mitigation of double taxation. United States

[24]The California court calls the results of such efforts "meliorative measures designed to pacify critics," App. C at 36, a clear invitation to the states to revoke such "measures" when they tire of "pacification."

[25]The Federal Executive has substantial power in the area of foreign affairs. *United States v. Curtiss-Wright Export Corp.*, 299 U.S. 304 (1936); *United States v. Pink*, 315 U.S. 203 (1942); *Youngstown Sheet & Tube Co. v. Sawyer*, 343 U.S. 579 (1952). In the absence of congressional action, executive action, particularly, as here, against a backdrop of enacted national policy designed specifically to deal with international division of income, is entitled to great weight. *Youngstown Sheet*, 343 U.S. 579; *Dames & Moore v. Regan*, 453 U.S. 654 (1981).

business benefits from this standardization. Other nations will not long tolerate increased taxes on their nationals from California's aberrant system, increased burdens of compliance arising from the requirement that their nationals respond to two separate systems to divide and report their international income among competing jurisdictions, and possible impact on their fiscs, without retaliating against American business.[26]

If a state of the United States which is economically the equivalent to the seventh or eighth largest nation in the world is permitted to promote its incompatible and inconsistent tax system, how can the United States seek the cooperation of its trading partners in adhering to the international standard? This Court's review is essential to prevent further erosion of these important federal policies.

3. THE CALIFORNIA COURT'S DETERMINATION THAT THE ADDITIONAL COMPLIANCE BURDENS FOR FOREIGN TAXPAYERS UNDER THE CALIFORNIA TAX SYSTEM DO NOT CONSTITUTE UNCONSTITUTIONAL DISCRIMINATION IS NOT RECONCILABLE WITH THIS COURT'S DECISIONS.

The problems with worldwide combined reporting do not end with consideration of its intrusion into the world of international relations. On a practical level, worldwide combined reporting also discriminates against foreign multinational groups in how it operates: it leaves such groups with a Hobson's choice of incurring excessive cost to set up an accounting system solely to capture and maintain information to properly file a California tax return, or forego possible tax benefits, an anticompetitive choice domestic corporations do not have to face. App. A at 26. Domestic corporations already have this information generally available for United States tax and financial accounting purposes and regularly collect such information in the normal course of business. Domestic corporations doing business abroad do not have to create a second and separate system to report their worldwide operations to the host country—since all nations, including the United

[26]The United Kingdom already has.

States, observe the international practice, and do not require inquiry beyond the operations of the entity in that country to file a tax return. Foreign multinational groups, however, have to create an additional and special system solely for purposes of complying with California's tax system. The cost to create and maintain such a system is significant.

The California Court of Appeal in its first opinion characterized compliance with worldwide combined reporting as an "administrative nightmare" for foreign based taxpayers.[27] App. B at 25. The court twice agreed that the costs of compliance with California's system were both significant and greater for foreign businesses than domestic businesses. App. B at 25, App. D at 9-10. Nevertheless, that court determined that such burdens were nondiscriminatory since California asked for the same information from and applied the same tax rate to all taxpayers.[28]

This exact kind of reasoning has been rejected by this Court several times. *Hunt v. Washington State Apple Advertising Comm'n*, 432 U.S. 333 (1977); *Tyler Pipe Indus., Inc. v. Washington State Dep't of Rev.*, 483 U.S. 232 (1987); *Pike v. Bruce Church, Inc.*, 397 U.S. 137 (1970). A state's power may not be used with the aim *or the effect* of establishing economic barriers against competition; i.e. it may not protect local commerce by placing a burden on competing out-of-state commerce. *Boston Stock Exchange v. State Tax Comm'n*, 429 U.S. 318, 329 (1977). Overt favoritism of local interests is not an essential element of discrimination, especially in the foreign arena. *Kraft*, 112 S. Ct. 2370; *Japan Line*, 441 U.S. at 434. In *Hunt*, this Court held that a North Carolina provision barring all grades, other than USDA, on sales of apples in closed containers had the *practical* effect not

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[27] The trial judge who heard the evidence describes in greater detail some of the problems. App. A at 26-28.

[28] Respondent adopted Regulation 25137-6 (App. J), which sets forth detailed provisions for proper filing of returns for multinational businesses. No foreign owned business can comply with the Regulation without either inordinate cost or the use of a relief provision solely within respondent's discretion. Regulation 25137-6 does not apply to interstate business.

only of burdening interstate sales of Washington apples, but also of discriminating against them. The discriminatory provision raised the costs of doing business in the North Carolina market for Washington apple growers and dealers, while leaving those of their North Carolina counterparts unaffected. The Washington growers had to scrap their system and institute new procedures for a state which represented less than 2% of their market. This Court pointed out: "the increased costs imposed by the statute would tend to shield the local apple industry from the competition of Washington apple growers and dealers who are already at a competitive disadvantage because of their great distance from the North Carolina market." 432 U.S. at 351. The new grading system also deprived the Washington growers of the benefits from their own recognized and accepted grading system.

In this case, the additional compliance burdens clearly raise the cost of doing business in the California market for foreign multinationals compared to their domestic competitors. Domestic businesses already have in place a compatible system for business done in the United States and domestic multinational business does not incur the incremental cost of responding to an entirely different set of worldwide information requirements when doing business in a foreign nation.

Moreover, California's aberrant system, with its different information requirements, has the effect of stripping away from foreign business the economic advantages of the limited reporting requirements under the international standard. United States multinational business retains the protection of the international standard when it goes abroad since no nation requires worldwide group information converted to that nation's tax accounting rules with the practical concomitant creation of a new worldwide system to capture such information. Further, the burden is exacerbated because a foreign multinational business tends to have more of its business outside the United States (in petitioner's case over 98%), whereas a United States multinational business will generally have a substantial portion of its business in the United States (with United States tax information readily convertible into California information). *Compare Hunt*, 432 U.S. 333; *Japan Line*, 441 U.S. 434. That the degree of discrimination may

vary vis-a-vis a domestic competitor is not significant. Once discrimination is established, the degree is inmmaterial. *See, e.g., Maryland v. Louisiana*, 451 U.S. 725, 759 (1981); *New Energy Co. v. Limbach*, 486 U.S. 269, 274-76 (1988).

Petitioner does not rely on cost alone although this Court has recognized that cost, taken into consideration with other factors, is a relevant inquiry in determining burdens on commerce. *Bibb v. Navajo Freight Lines, Inc.*, 359 U.S. 520 (1959). For example, in *Pike v. Bruce Church, Inc.*, 397 U.S. at 145, the construction of a packing operation in Arizona at a cost of $200,000 was significant in determining unconstitutional discrimination.[29] *See also Raymond Motor Transp., Inc. v. Rice*, 434 U.S. 429, 445 (1978) (state regulation on length of trucks imposed substantial cost on movement of goods interstate); *Toomer v. Witsell*, 334 U.S. 385, 404-04 (1948) (cost of packaging and stamping shrimp in the state). Here, the California system also forces foreign multinational businesses into the choice of setting up a costly compliance system or foregoing tax benefits.[30]

Worldwide combined reporting is a modern prototype of the "drummer" cases, where state taxes or other requirements placed out-of-state taxpayers at a commercial disadvantage.[31] Asking for the same information when one party does not have the information is not any more even-handed than requiring all apple growers in North Carolina to use the same system. And, in practice,

[29]The Superior Court found in this case that the cost to reconstruct, set up and maintain a system was "huge, over $5,000,000.00 to establish and over $2,000,000.00 annually to maintain. Such amounts are conceded by FTB to be unreasonable if true; but they are claimed unnecessary for proper compliance. I find them so necessary." App. A at 27-28.

[30]As this Court found in *New Energy Co.*, 486 U.S. 269, unconstitutional commercial disadvantage can arise from denial of tax benefits.

[31]Drummers were travelling salesmen. Localities concocted license and other schemes which in practice only applied to the out-of-stater. *See Robbins v. Shelby County Taxing Dist.*, 120 U.S. 489 (1887); *Best & Co. v. Maxwell*, 311 U.S. 454 (1940); *Nippert v. City of Richmond*, 327 U.S. 416 (1946). *See also American Trucking Ass'ns, Inc. v. Scheiner*, 483 U.S. 266 (1987).

foreign taxpayers do not pay at the same effective rate where, lacking the proper information in the proper form, they file on a different—and generally higher—tax base.

The California court's decision cannot be reconciled with this Court's decision on discrimination under the Commerce Clause.

4. CALIFORNIA'S FILING REGULATION VIOLATES DUE PROCESS AS FOREIGN MULTINATIONALS MUST FILE UNDER A STANDARDLESS RELIEF PROVISION AND NEGOTIATE THEIR TAX LIABILITY TO AVOID BURDENSOME COSTS OF COMPLIANCE.

This Court's decisions require that a statute or regulation contain sufficiently explicit standards, not only for a person of ordinary intelligence to understand what conduct is prohibited, but also to prevent arbitrary, harsh and discriminatory enforcement by government officials. *Grayned v. City of Rockford*, 408 U.S. 104, 108 (1971); *Kolender v. Lawson*, 461 U.S. 352, 360 (1982); *Papachristou v. City of Jacksonville*, 405 U.S. 156, 162, 168-69 (1972).

A foreign taxpayer cannot file a California combined return in accordance with the mandated provisions of Regulation 25137-6 without inordinate cost. Such a taxpayer must rely on the discretion of respondent under subdivision (e) of that Regulation (App. J at 8) to accept something in lieu thereof. The Court of Appeal determined when respondent must accept "reasonable approximations" of required data (when it is too costly), but not what respondent must accept. Where as here a taxpayer negotiates the "what" under threat of penalty[32] the result is a non-uniform set of compliance rules. A non-uniform rule encourages arbitrary and discriminatory enforcement. *Southern Coop. Dev. Fund v. Drig-*

[32]Respondent threatened penalties for failure to produce detailed—and confidential—information from at least one other foreign taxpayer. See *EMI Ltd. v. Bennett*, 560 F. Supp. 134 (N.D. Cal. 1982), *aff'd*, 738 F.2d 994 (9th Cir. 1981); *Capitol Industries-EMI, Inc. v. Bennett*, 681 F.2d 1107, 1110-11 (9th Cir.), *cert. denied*, 455 U.S. 943 (1982).

gers, 696 F.2d 1347 (11th Cir.), *cert. denied*, 463 U.S. 1208 (1983).

Judicial review cannot cure an enactment when the standard of enforcement is not explicit or when enforcement rests in the effectively standardless discretion of the administering agency. *Interstate Circuit, Inc. v. City of Dallas*, 390 U.S. 676, 685 (1968); *Yick Wo v. Hopkins*, 118 U.S. 356 (1886). Moreover, negotiating their tax returns means that foreign taxpayers in essence file on a different tax base than others, resulting in equally unconstitutional discrimination.

A system without predictable consistency cannot be reconciled with this Court's requirements under the Due Process Clause.

CONCLUSION

This Court has established a framework for analysis of burdens under the foreign Commerce Clause. The California court has not only jettisoned the analytical framework created by this Court in *Japan Line* and *Container*, it has essentially embraced an approach which this Court has rejected many times, namely that the states are free to tax until Congress tells them to stop. *See, e.g., Japan Line*, 441 U.S. at 454-55; *Southern Pac. Co. v. Arizona ex rel. Sullivan*, 325 U.S. 761, 769 (1945). The decisions below cannot be reconciled to the principles established by this Court and carry grave dangers of harm to the Nation. For the foregoing reasons this Court should grant this petition for Writ of Certiorari.

Respectfully submitted,

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92-1384

No. (2)

In the Supreme Court

OF THE

United States

OCTOBER TERM, 1992

BARCLAYS BANK PLC
Petitioner,

vs.

FRANCHISE TAX BOARD,
An Agency of the State of California
Respondent.

APPENDICES TO PETITION FOR A WRIT OF CERTIORARI TO THE COURT OF APPEAL OF THE STATE OF CALIFORNIA IN AND FOR THE THIRD APPELLATE DISTRICT

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SUPERIOR COURT OF CALIFORNIA, COUNTY OF SACRAMENTO

BARCLAYS BANK INTERNATIONAL LIMITED,
a Corporation of the Country of England,
Plaintiff,
vs.
FRANCHISE TAX BOARD,
an Agency of the State of California,
Defendant.

BARCLAYS BANK OF CALIFORNIA,
a California corporation,
Plaintiff,
vs.
FRANCHISE TAX BOARD,
an Agency of the State of California,
Defendant.

No. 325059
No. 325061
(Consolidated for Purposes of Trial)

ENDORSED:
Filed August 20, 1987

JOYCE RUSSELL SMITH, CLERK
By S. GODFREY, Deputy

STATEMENT OF DECISION

The Court hereby adopts in full its "INTENDED DECISION" of June 16, 1987, and hereby files it as attached hereto, as the Court's "STATEMENT OF DECISION".

DATED: August 20, 1987.

GEORGE E. PARAS
Judge of the Superior Court
Pro Tem

SUPERIOR COURT OF THE STATE OF CALIFORNIA
COUNTY OF SACRAMENTO

BARCLAYS BANK INTERNATIONAL LTC.,
a Corporation of the Country of Engl..nd,
Plaintiff.
vs.
FRANCHISE TAX BOARD,
an agency of the State of California,
Defendant.

BARCLAYS BANK OF CALIFORNIA,
a California corporation,
Plaintiff.
vs.
FRANCHISE TAX BOARD,
an agency of the State of California,
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INTENDED DECISION

I
STIPULATED FACTS

Pursuant to written stipulation of the parties (Exhibits 1 and 2), the facts therein stipulated are found to exist. Said stipulations are attached hereto as Schedules 1 and 2 respectively. Additional findings of fact on disputed matters are made during the course of this Intended Decision.

II
JURISDICTIONAL ISSUE

Defendant Franchise Tax Board (FTB) renews its jurisdictional claim (denied on a motion in limine [RT Page 136-138] at the outset of the trial) that because Plaintiffs assertedly failed to mention in their protest (the procedural equivalent here of a "claim") that a basis thereof was unconstitutionality deriving from interference with the *Federal Executive Branch's* conduct of foreign affairs, they are precluded from relief on that basis at trial. This issue is again resolved against Defendants on two grounds; first, the protest and proceedings thereon did give adequate notice, and second, if the tax as here applied is unconstitutional on any ground the FTB did not have jurisdiction so to adjudicate it, hence the presentation of such a specific claim would have been a futile act. This ruling is fortified by *Park 'N Fly of San Francisco, Inc. v. South San Francisco* (1987) 188 Cal App 3d 1201.

FTB's request for judicial notice of Friendship, Commerce and Navigation (FCN) Treaties with France, the Federal Republic of Germany, Japan, and the Netherlands is granted.

III
JAPAN LINE, CONTAINER, AND WARDAIR CASES

Three U. S. Supreme Court Cases decided within the past eight years are absolutely vital to the position of both parties. They are *Japan Lines Ltd. v. County of Los Angeles* (1979) 441 U.S. 434, *Container Corporation of America v. Franchise Tax Board* (1983) 463 U.S. 159, and *Wardair Canada v. Florida Department of Revenue* (1986) 477 U.S. ____; 106 S.Ct. 2369.

Before I can rule on the various contentions it seems to me essential that I analyze and offer my interpretation of each decision, both as it affects this case and as it affects the other two. I do this with unqualified respect for contrary interpretations by the parties and by others. We are in a highly complex area of constitutional law, so complex that it's exposition in a given case necessarily occasions varying nuances of judicial expression and intendment, not all of which are or can be perceived identically by every reader and some of which are themselves at times not totally consistent. Even so, it is hopeless to undertake a resolution of the issues here without a basic exposition of the legal significance of these three cases as seen by this Court.[1]

A. *JAPAN LINE*

The first case in the trilogy involved an ad valorem property tax by Los Angeles County on large containers owned and used by Japanese companies in connection with their international marine shipments of goods strictly in foreign commerce. The containers only "stopped off" for short periods at foreign (to Japan) ports like Los Angeles in the course of their international journey. The Supreme Court invalidated the tax on foreign commerce constitutional grounds.

Initially it is notable that the Court's analysis did not involve due process and the 14th Amendment (441 U.S. at 439, FN. #3); thus it can be of no help to us here as to Plaintiff's due process claim. Nor did it address the question of participation of the Executive Branch in the conduct of foreign affairs; thus, it is of no assistance in resolving that issue either.

The Court might have grounded its holding on the common law "Home Port Doctrine" (*Hays v. Pacific Mail S. S. Co.*, (1985) 17 How. 596), but expressly refused to do so (441 U.S. at 442-444), saying: "The question here is a . . . narrow one, that is, whether instrumentalities of commerce that are owned, based, and registered abroad, and that are used exclusively in international commerce, may be subjected to apportioned ad valorem property taxation by a State." Rather the court moved directly into the Commerce Clause, Article I Section 8, Cl. 3 of the Federal Constitution. It reviewed its own holdings regarding state taxes in the interstate commerce area, including "instrumentalities of interstate commerce", and reiterated the applicable four pronged test for determining constitutionality (substantial nexus, fair apportionment, non-discrimination, and fair relation) as enunciated in *Complete Auto Transit, Inc. v. Brady* (1977) 430 U.S. 274, and *Washington Revenue Dept. v. Association of Wash. Stevedoring Cos.* (1978) 435 US 734. Rejecting the taxing authority's contention that the Commerce Clause analysis is identical in a foreign as well as an interstate context, it stated that "[w]hen construing Congress' power to regulate commerce with foreign nations', a more extensive constitutional inquiry is required." (441 US at 446) It then enunciated the now firmly established and accepted two additional criteria, enhanced risk of multiple taxation and potential impairment of federal uniformity in areas in which such uniformity is essential (441 US at 446 to 451).

As to the first criterion, the Court stressed the absence of any authoritative tribunal capable of ensuring against a double tax burden in the international area, in contrast with its own power so to ensure in the interstate area. It indicated the foreign country of domicile of an instrumentality of commerce "*may* have the right *consistently with the custom of nations* to impose a tax on its full value. [fn omitted] If a state should seek to tax the same instrumentality on an apportioned basis, *multiple taxation inevitably results.*" (emphasis added) (441 US at 447). "A . . . state tax, even though 'fairly apportioned' . . . *may* subject foreign commerce to the *risk* of a double tax burden to which (domestic) commerce is not exposed, and which the Commerce Clause forbids' ". (emphasis added) (441 US at 448). The Court pursued this point by indicating the ad valorem tax created more than the *risk* of double taxation; based on a stipulation and a trial court finding, Japan in fact taxed the same items at full value, hence there was an undeniable double tax (thus the Court did not elaborate on what circumstances would cause the mere *risk* of double tax to come into play constitutionally) (441 US at 452,

[1]It goes without saying that *Japan Line*, *Container* and *Wardair* are not the only authorities affecting this decision. The multitude of other cases have been studied and considered, and appropriately enter into the result.

incl. FN 17). To the assertion that it is Japan's levy that creates the double tax, not California's (Los Angeles County's), the Court responded with "California's tax, however, *must be evaluated in the realistic framework of the custom of nations.* Japan has the right and the power to tax [the] containers at their full value; nothing could prevent it from doing so." (emphasis added) (441 U.S. at 454.) Similarly it rejected a claim that since Congress has not acted a State may act, in favor of a Dormant Commerce Clause concept, stating "California may not tell this nation or Japan how to run their foreign policies" (441 U.S. at 454-455). Finally, the Supreme Court distinguished *Moorman Mfg v. Bair* (1978) 437 U.S. 267, on the basis primarily that it concerned interstate commerce, but confirmed in the process "that the Commerce Clause 'does not call for mathematical exactness nor for the rigid application of a particular formula; only if the resulting valuation is palpably excessive will it be set aside.'" (441 U.S. at 455).

As to the second criterion, the Supreme Court stressed the concept that the Foreign Commerce power of Congress is greater than its Interstate Commerce power, emphasizing "the need for uniformity in treating with other nations" and "the framers overriding concern that 'the federal government must speak with one voice when regulating commercial relations with foreign governments'" (441 U.S. at 448-449). The Court gave illustrations of how the subject tax *may* frustrate federal uniformity, as by resulting international disputes over reconciling apportionment formulae, by retaliation from other nations to the detriment of the United States as a whole, and by other states of the United States than California also taxing the same subject, "a result which would plainly prevent this nation from 'speaking with one voice' in regulating foreign commerce." (441 U.S. at 450-451). The Court cited the mutual participation of the United States and Japan in the Customs Convention on Containers as the source of desirability for uniform treatment of containers; the Convention stated that containers temporarily imported are free from "all duties and taxes whatsoever", a national policy of federal uniformity that the subject tax will frustrate. The Court brought into the case an element of "reciprocity" by indicating that since American-owned containers are not taxed in Japan, the tax creates an

asymmetry to Japan's disadvantage, thereby creating an acute risk of Japanese retaliation (441 U.S. at 452-453). A form of nascent immediate and direct retaliation was recognized by the Court, the European Economic Community's determination to consider "suitable counter-measures" when informed of California's tax.

Several further observations on the *Japan Line* decision are in order. On first reading, it appears to hold rather unequivocally that the four requirements for interstate tax validity are met. On more careful reading however it is seen that the *Japan Line* Court only assumes, without deciding, that the requirements are satisfied so that it may proceed to the foreign affairs discussion (441 U.S. at 445, 451). This is important to us only with reference to the claim by the Plaintiffs that the four interstate standards have not fully been met (POB Page 154-162) and the FTB's counter argument that they have been met as a matter of law (DB Page 17-21). *Japan Line* does not foreclose Plaintiffs from pursuing their position in this regard.

Japan Line deals with a tax on an "instrumentality of commerce", foreign commerce. It does not tell us whether a foreign parent of a domestic corporation or a foreign corporation doing business in California is an instrumentality of commerce that must be determined from other authorities.

Japan Line involved a tax on tangible personal property not income, a more abstract form of property. Seizing on this difference, one can argue that all the *Japan Line* pronouncements are dicta as they apply to this case. In the judicial sphere what is dictum and what is legal pronouncement are more frequently than not determined by later judicial inclination. The *Japan Line* doctrines were however treated as law, not dicta, by the *Container court* (see infra). There is a distinction, for obviously there are differences between a cargo container and a corporate entity; and certain legal principles applicable to one need not apply to the other. But to the extent that the U.S. Supreme Court makes special pronouncements on a subject which readers find reasonably applicable to a variation of the subject or to a wholly different subject, those pronouncements are, to this judicial officer at least, controlling law; only the Supreme Court itself should declare them inapplicable as dictum or otherwise.

The case is very strong in its expressions regarding sensitivity of foreign affairs to any intrusions by individual states. Although finding the existence of an actual double taxation, it clearly applies its rule of law to potential double taxation depending upon appropriate "considerations", which it does not define except that they must constitute a substantial burden on foreign commerce (although any burden thereon is suspect). It is almost insistent in its demand that in foreign matters, at least with specific aspects thereof, the federal government alone be involved (one voice). As to its judicial effect upon a unitary tax case such as FTB's, assuming the context of a foreign corporation doing domestic business either directly or through a subsidiary, *Japan Line* is strongly supportive of Plaintiff's foreign commerce claim. It recognizes the "custom of nations" as a significant foreign affairs concept. It reaffirmed the Dormant Commerce Clause principle. It viewed as significant in the foreign affairs context the role of reciprocity (a tax by foreign nations on American companies or property balanced by a comparable American tax on foreign companies or property) and the correlative concept of asymmetry.

B. *CONTAINER*

This decision is so very close to the present case that its every aspect must be examined carefully for its effect hereon. It involved the same State (California), the same agency (Franchise Tax Board), and the same tax (income). The sole juridical difference is that it involved a domestic parent corporation (Delaware — headquartered in Illinois), with foreign subsidiaries doing business and being taxed in California; while here we have a foreign (United Kingdom [UK]) parent corporation whose foreign (UK) subsidiary, directly and through its California subsidiary (Barclays Bank of California [BARCAL]) did business in California and was naturally subject, as was BARCAL, to California income taxation. The specific issue of constitutionality of the application of California's unitary taxation method, known also as World Wide Combined Reporting (WWCR) to a Barclay type business group was reserved expressly by *Container* (463 U.S. at 189, FN 26 and 19[illegible], FN 32). Three questions were presented literally to the *Container* Court for its review: (1) Whether the business group was properly a

"unitary business" for purposes of the tax, (2) If so, did the WWCR method as applied to the Container network of corporations violate the constitutional requirement of "fair apportionment"? And (3) Did California have an obligation under the Foreign Commerce Clause to employ the "arms-length" method used by the Federal Government? (463 U.S. at 165). Though the Supreme Court thus phrased the third question, it is but another way of asking whether WWCR was constitutionally appropriate. *Container* held that the group there involved was properly "unitary", that the apportionment was fair, and that the use of WWCR did not violate the Foreign Commerce Clause.

Here there is no issue of whether the Barclay group is properly a unitary group, that question having been conceded by the Plaintiffs for purposes of this case.[2] *Container's* discussion thus affects us as to its second and third questions. It is notable however that *Container* reaffirmed the general rule that under both the Due Process and Commerce clauses a state may not "tax value earned outside its borders" when imposing an "income-based" tax. But because businesses operating across state lines make precise territorial allocations of value impossible, States have been permitted constitutionally to use "formulae" for apportionment, with the taxpayer having the distinct burden of showing by "clear and cogent" evidence that a challenged tax falls on extraterritorial values (463 U.S. at 164).

On the question of fair apportionment, *Container* emphasized the taxpayer's burden to prove that the income apportioned to itself by the taxing entity and its methodology is "out of all appropriate portion to the business transacted" within that entity (463 U.S. at 180-181). In this regard the Court noted the argument that the foreign subsidiaries are significantly more profitable (that argument also is made here by Plaintiffs — POB Page 149-154), and California's three factor formula systematically distorts the true allocation. Citing *Mobile Oil Corp. v.*

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[2] There is a secondary issue however as to whether within the rubric of determination of the unitary group and application of an apportionment formula to it, the formula is "fair" (463 U.S. at 169 — POB Page 154 et seq.). It will be addressed in due course.

Commissioner of Taxes (1980) 447 U.S. 207, the Court rejected this argument in the face of considerable evidence supporting such distortion; such evidence "does not by itself come close to impeaching the basic rationale of the three factor formula" (463 U.S. at 182). As an example of a distortive effect "outrageous" enough to sustain the taxpayer's burden, the Supreme Court presented a formulary attribution of 66% to 85%, struck down in *Hans Rees' Sons, Inc. v. North Carolina Ex. Rel. Maxwell* (1931) 283 U.S. 123, compared to below 21.7% under a separate accounting analysis in *Container* (463 U.S. at 180-181). Observing that the percentage increase in *Container's* facts from the taxable income as filed to the taxable income as revised by WWCR was but 14% compared to over 250% in *Hans Rees'*, the Court concluded on this issue that the 14% figure was "certainly within the substantial margin of error inherent in any method of attributing income among the components of a unitary business" (463 U.S. at 184). The evidence in this case (Barclay) indicates that the final tax figures for 1977 after the protest procedure resulted in a combined tax increase for both Barclays Bank International Ltd. (BBI) and BARCAL from an aggregate of $555,724.03 to $859,822.03, a difference of 28%; the taxable income figures are comparable. Given the strong language of *Container* on the issue of fair apportionment and the very heavy burden placed upon the taxpayer on this issue, coupled with the fact that the *Container* Court had before it and considered substantially the same evidence as was presented here (except perhaps the evidence on costs of compliance), I conclude that the use of WWCR here did not apportion income to BBI and BARCAL in an amount "out of all appropriate proportion to the business transacted" in this State. I make the same ruling with regard to Plaintiffs' claim of unfairness of the formula per se as applied to foreign multi-state corporations. While *Container* has its two "fairness" concepts, one respecting the formula (463 U.S. at 169) and the other respecting the apportionment (463 U.S. at 180), I discern no appreciable difference between the two. The opinion discusses both in the context of the "all appropriate proportion" burden. Moreover I do not conclude that cost of compliance is a factor entering into the fair apportionment and fair formula rules, which in my opinion focus upon the tax itself and its treatment of

multiple entity income, not with the taxpayer's burden or cost. To the extent therefore that Plaintiffs claim unconstitutionality of the use of WWCR on grounds of fairness or fair apportionment, my decision is in favor of FTB.

The *Container* case proceeded to the "additional scrutiny required by the foreign Commerce Clause .... The case most relevant ... is *Japan Line.*" (463 U.S. at 185). This disposes undeniably of any potential claim that *Japan Line* is distinguishable and not controlling as to its enunciation of certain principles of law because it involved a property and not an income tax. The Supreme Court certainly did not so consider it, although it was mindful of its factual basis.

The Court found four important similarities to *Japan Line,* (1) There was actual double taxation by California and foreign nations in both cases (which FTB does not here seriously dispute), (2) The double tax stems from seriously divergent taxing schemes of the taxing authorities, (3) The foreign taxing scheme is consistent with "accepted international practice", and (4) The Federal Government "seems to prefer" the international (arm's length) taxing method (463 US at 187). The Court also found three clear distinctions from *Japan Line*, (1) *Japan Line* involved a property tax, (2) the double tax in *Container* is not the inevitable result of California's tax scheme, and (3) the tax does not fall on the "foreign owners of an instrumentality of foreign commerce, but on a corporation domiciled and headquartered in the United States." (463 US at 188) Referring to its reservation of the *Japan Line* holding's application to "domestically owned instrumentalities engaged in foreign commerce," it then stated "... to the extent that corporations can be analogized to cargo containers in the first place — this case falls clearly within that reservation" (463 US at 188-189).[3]

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[3]This disposes to my satisfaction of the question of a corporation being or not being an "instrumentality of commerce." Despite disagreement on this question (DB p. 45-46), the quoted statement from Container makes it clear, along with the rest of the opinion, that a corporation for legal and constitutional purposes is treated as an instrumentality of commerce, whether actually it is or not.

The court went on to expatiate on the similarities and dissimilarities to *Japan Line*. It reaffirmed the literal *Japan Line* expression that "even a slight overlapping of tax — a problem that might be deemed *de minimis* in a domestic context — assumes importance when sensitive matters of foreign relations and national sovereignty are concerned." Taking into account the context of the *Container* tax, which the rule itself requires, and the fact that even the adoption of an arm's length method would not guarantee an end to double taxation, the Court found the rule not determinative (463 US at 189-193), pointing out here again the distinction between a property tax and an income tax (463 US at 192).

Proceeding to *Japan Line's* impairment of uniformity and speaking with one voice concepts, the Court uttered the phrase: "In conducting this inquiry . . ., we must keep in mind that if a state tax merely has *foreign resonances*, but does not *implicate* foreign affairs, we cannot infer, 'absent some explicit directive from Congress . . . that treatment of foreign income at the Federal level *mandates identical treatment* by the States.'" (Emphasis added) (463 US at 194). The Court continues: ". . . a state tax at variance with Federal policy will violate the 'one voice' standard if it *either* implicates foreign policy issues which must be left to the Federal Government *or* violates a clear Federal directive [a species of pre-emption]." (463 US at 194) Here the Court went on to explain its problem, that as a Court (presumably in the absence of specific evidence) it has little competence in determining when a foreign government is or will be offended and in how to balance a risk of retaliation against the sovereign right of the United States to let States tax as they please. "The best we can do . . . is to attempt to develop objective standards . . . about the imperatives of international trade and . . . relations." (463 US at 194). For three reasons, the Court concluded against the possibility of justifiable foreign retaliation, first there was no automatic asymmetry in *Container* second the tax was imposed not on a foreign entity but on a domestic corporation ("The legal incidence of the tax falls on the domestic corporation"), and third the California tax rate could be raised, thereby having the same financial foreign effect; and whether so or no, the offense to the foreign entity would be attenuated (463 US at 194-195). With reference to the

second reason, the Court inserted a footnote pointing out that this tax effect on a domestic corporation "might be less significant if the domestic corporation was owned by foreign interests".

The Court then noted the absence of a United States Amicus Curiae Brief, which though not dispositive was suggestive that United States foreign policy ("whose nuances . . . are much more the province of the Executive Branch and Congress than of this Court") was not seriously threatened by California's WWCR (463 US at 196). This clarifies the role of the United States as an Amicus — its presence in that capacity is not merely as a traditional "friend of the Court" with the Attorney General as its lawyer, but is a substantive exposition of the Executive's view of foreign affairs implications in this unique type of case. Were it otherwise as a matter of the Supreme Court's law, the *Container* court would not have mentioned it in so positive a way. This judicial statement also is an indication of the significant role of the Executive in foreign affairs, confirming that despite the literal language of Article I, Section 8, Cl. 3, giving *Congress* control over foreign affairs, that control is shared between the Congress and the Executive (with Congress supreme as between the two). There is no truly serious disagreement on this between the parties, although they expectably disagree as to its application in this case.

After thus concluding that foreign affairs were not implicated by California's unitary tax in a domestic corporation context, the *Container* Court went on to the final consideration that a "clear Federal directive", if present and proscriptive of WWCR, would have voided the latter's use by the FTB. It found none. There was no Federal statute, despite long debates in Congress. The numerous Tax Treaties of the United States require it to adopt some form of arm's length analysis in taxing the domestic income of multinational enterprises, but "that requirement is generally waived with respect to the taxes imposed upon each of the contracting parties on its own domestic corporations. This fact, if nothing else, confirms our view that such taxation is in reality of local rather than international concern." (463 US at 196). The tax treaties do not apply the arm's length requirement to the States. Finally, the Senate "reserved" a clause making the re-

quirement applicable to the States in the process of ratifying the 1977 US-UK Treaty.

By way of general commentary on the case, it appears that *Container* receded somewhat from the stronger one voice position of *Japan Line*. Where *Japan Line* was almost eager to anticipate retaliation, *Container* professed practical impotence on the subject. The very large emphasis of the case in distinguishing *Japan Line* was in two areas, the income vs. property tax distinction and the domestic vs. foreign corporate tax effect. The foreign commerce power was recognized as exercisable and exercised by both the Executive and Legislative branches. The Tax Treaties and their content were considered. The Senate's reservation of Clause 9(4) from the US-UK Tax Treaty of 1977 was mentioned to suggest an absence of intention by Congress to occupy the State tax field.

C. *WARDAIR*

Florida imposed a sales tax on aviation fuel purchased within its boundaries by Wardair, a Canadian corporation which operates charter flights between Canada and the United States. Wardair claimed the tax was precluded by the Foreign Commerce Clause and a clear directive of Congress implicit in the Federal Aviation Act (FAA). The Supreme Court held, "We disagree . . . and find that Congress has not acted to preempt state taxes such as that imposed by Florida. Accordingly we affirm. . . ." (106 S.Ct. at 2370).

Congress has not occupied the field by enacting the FAA, states the Court. Where a Federal statute does not expressly preempt a state law and there is no actual conflict between the two laws, "we have required that there be evidence of a Congressional intent to pre-empt the specific field covered by the state law" (106 S.Ct. at 2372). Instead of precluding this tax, the FAA expressly permits it, but in general terms ("taxes on the sale of goods and services"). But it may be that Congress didn't consider in the FAA that *foreign* carriers could be taxed, so the Court did not rely on that enactment to answer the Commerce Clause issue; but it answered Wardair's pre-emption argument (Ibid).

The Court then turned to Dormant Commerce Clause considerations, explaining that this doctrine is grounded on the absolute need for uniformity even where Congress has not acted (106 S.Ct. at 2373). It reviewed the four basic tests involved in interstate (and foreign) commerce matters and the additional two that must be considered where foreign commerce is involved. The first four tests were not involved in the case; nor the first of the next two, because no double tax existed in a "discrete" sales tax context. Only the last, the one voice test, was involved, with Wardair and the United States (as Amicus, through the Solicitor General) urging the existence of a Federal policy in the taxation of instrumentalities of international air traffic. The Supreme Court disagreed, holding that the evidence showed no such Federal policy but on the contrary a policy *permitting* such taxation, so that no Dormant Commerce Clause discussion at all was needed (106 S.Ct. at 2373-2374).

From a study of the Chicago Convention on International Civil Aviation of 1944, a 1966 "Resolution" of the International Civil Aviation Organization, and more than 70 bilateral agreements (to all of which the United States was a party), the Court concluded that while there is an international *aspiration* to eliminate a fuel tax, the law currently *acquiesces* in such tax by political subdivisions of countries. The Chicago Convention demonstrates international awareness of the problem of state and local taxation of aviation fuel and a decision to limit it in some respects but not this one. The Resolution, while clearly opposing such a tax, has not been "signed, entered into, agreed upon, approved or passed by either the Executive or Legislative branch of the Federal Government"; it is merely the work product of an organization of which the United States is a member. It is not a policy of the United States (106 S.Ct. at 2374-2375).

The *Wardair* Court notes that since the Chicago Convention, the United States became a party to each of the over 70 bilateral agreements, all of which forbid federal taxes on aviation fuel but none of which, including the one with Canada eight years after the Resolution, interdict it at the local level. "By negative implication arising out of more than 70 agreements entered into since the Chicago Convention, the United States has at least

acquiesced in state taxation of fuel used by foreign carriers in international travel." This is an affirmative decision to permit this tax (106 S.Ct. at 2375).

Wardair adds to our understanding of the Supreme Court's teachings in the area of state taxation of foreign commerce the following. Federal policy in a given area of foreign affairs may be found by negative implication from a series of international agreements entered into by the United States (presumably negotiated and executed by the Executive and ratified by the Senate) with knowledge of a specific problem or concern, in which the latter is ignored, while focusing on another, but related, problem. Federal policy will not be found by mere membership in an international organization which itself expresses a policy on a subject of international concern.

IV

RESOLUTION OF ISSUES

Plaintiffs divide their post-trial briefing arguments into four headings, (1) WWCR infringes upon the exclusive power of the Federal Government to deal with foreign affairs; (2) WWCR violates the Supremacy Clause (pre-emption); (3) WWCR impermissibly burdens commerce; (4) WWCR discriminates against foreign commerce and ~~is internally~~ inconsistent, in violation of the Commerce and Due Process clauses; and (5) as applied to foreign based unitary groups, WWCR deprives them of property without due process. FTB argues (1) Plaintiffs have not sustained the burden of proving both illegality of FTB's tax *and* the correct amount if Plaintiffs are correct; (2) Plaintiffs are barred as to the foreign affairs issue by failure to exhaust administrative remedies; (3) Congressional foreign policy prevails over that of the Executive; (4) *Container* and *Wardair* compel judgment in FTB's favor; (5) even under a Dormant Foreign Commerce clause analysis, WWCR is not a violation; (6) Plaintiff's burden on cost of compliance with WWCR as a Constitutional violation has not been met; (7) FTB's procedures on WWCR do not violate due process; and (8) this court has no jurisdiction to impose a "Water's Edge" rule on FTB. A ruling adverse to FTB's

second point has heretofore been made; the others remain. Considerable overlap is noted between and among a number of the contentions of both parties. It is inevitable, for as heretofore observed specifically with a segment of the *Container* case, the various operative doctrines themselves overlap. Necessarily also this court's resolution of the tendered issues will overlap.

A. *WWCR AS AN INFRINGEMENT ON THE FOREIGN AFFAIRS POWER*

As a general rule, there is no doubt (nor any disagreement between the parties) that in the area of Foreign Commerce, the power of the Federal Government is exclusive. Any infringement upon that power by state legislation is prohibited constitutionally (*Zschernig v. Miller* (1968) 389 U.S. 429; *Bethlehem Steel Corp. v. Bd. of Comm'rs* (1969) 276 CA 221).

Plaintiffs proceed to assert that the WWCR tax method of California *implicates* foreign commerce. There is no doubt that it does, but does it do so in the *Container* sense (463 U.S. at 194), i.e., implicate rather than resonate? From the evidence presented to this court, I conclude that WWCR, as applied to foreign multinationals, implicates foreign commerce within the meaning of *Container*.

Historically, although there has existed for many years the unitary method of taxation by California, it never was seriously a factor in foreign affairs until "the early 1970's"[4] when California first applied it to foreign multi-national corporations. Thus, we cannot measure American or foreign governmental reaction to its international use by events prior to 1972, including the negotiations and ratifications of foreign Tax Treaties. Moreover, we cannot realistically determine such reaction until the FTB's expanded application had time to be felt by taxpayers, through FTB audits and assessments, protests, negotiations between foreign nations and the United States, etc. Thus, the multitude of Tax Treaties entered into and ratified prior to 1978, which tacitly permit state taxation of foreign businesses (subject, of course, to

[4]To achieve some degree of precision I find the specific year to be 1972.

the four *Complete Auto* test for interstate commerce) are of no value to us here, as they were in *Wardair*. A given topic cannot have a realistic impact on foreign affairs until it arrives on the scene.

The interplay of the executive and legislative role in Foreign Affairs must here be given attention. They both act in the Foreign Commerce and Foreign Affairs area, with Congress in ultimate charge, either by treaty ratification or by direct legislation (see *United States v. Curtiss-Wright Export Corp.* (1936) 299 U.S. 304); *United States v. Pink* (1942) 315 U.S. 429). A federal policy is formulated by either branch, and it will not be presumed that they are at variance, although from time to time, variance doubtless exists. No such variance can be found here from the Senate's failure to ratify the 1975 UK-US treaty in its entirety. In 1975, in direct response to California's extension of WWCR to foreign, including British, multi-nationals, Clause 9 (4) was inserted into the new UK-US Tax Treaty (signed on December 1, 1975) which for the first time in tax treaty history, would have proscribed the tax as levied here. The Treaty reached the Senate in 1978. In the Senate Foreign Relations Committee, Senator Frank Church (of Idaho, one of the State's then taxing by the unitary method) introduced a "reservation" to 9(4): it was defeated 10 to 5. On the Senate floor, the reservation again was defeated 44 to 34. The treaty as signed then received a vote of 49 to 32, five votes short of the ⅔ needed. Thereafter 9(4) was reserved without a vote and the treaty was ratified with the reservation. It was later approved by the British Parliament, but only after strong assurances by our Executive that the matter would be yet resolved (as indeed it partly was; inter alia, by California's 1976 legislation allowing a Water's Edge method effective 1/1/88) to eliminate WWCR with reference to UK multinationals. Am I to conclude from that a Congressional "foreign policy" *favoring* WWCR income taxation of foreign multinationals by individual states? No. Not in the face of three majority votes (one in committee and two on the floor) favoring

discontinuance of the practice.[5] If it shows anything at all, it is a Congressional preference, not rising to the dignity of a policy, favoring the elimination of WWCR in a foreign multinational context. Meantime the evidence shows unequivocally that the Executive branch all along, under three administrations since the WWCR problem in the present context became known, has steadfastly adhered to a policy of use of the arms length/separate accounting (AL/SA) method and not WWCR, both as to the States and the Federal Government.

FTB may argue somewhat logically that the negotiation, execution, and ratification of numerous tax treaties without 9(4) since 1978, with consequent knowledge of the Senate's action, shows a policy favoring whatever method, including WWCR, a state wishes to use. Indeed there is some prima facia support in *Wardair* for this position. But what was lacking in *Wardair* was (1) the consistent and continual Executive expression of policy and (2) the actual 1978 Senatorial episode, the only time Congress (or at least one-half of it) actually focused on WWCR in the international context. The Executive's foreign policy can only be what the Executive says it is, by official communication to foreign nations, by similar communication to the states and to Congress, by Amicus briefs, etc. (that is why none of this is hearsay). In one respect only has the Executive arguably varied from its policy, when it withdrew support for pending legislation in the Congress; but that is nothing more than a preference of methodology to achieve its policy, not a change of it. The Congressional foreign policy likewise can only be what Congress says it is. But what the Congress says, it says by affirmative legislation, or secondly by rejection of proposed legislation or to some extent by Senate action on Treaties; or possibly by implica-

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[5]This ruling is not inconsistent with *Container's* reference to the Senate vote in support of its rejection of the claim made there. I note no analysis of the Senate action by the Supreme Court; more important the *Container* Court used this as an example of *no* congressional policy, not as establishing affirmatively a policy for or against.

tion from Congressional enactments. But Congress cannot otherwise have an "intent", being the collegial body that it is.[6]

There is an international standard of accounting universally practiced by all nations of the world, including the United States, the AL/SA method. It is used to determine income of business entities derived from operations in countries other than their own, for purposes of income taxation by those countries. It operates on the assumption that only the income actually earned within a foreign country should be taxed by it (no double taxation), but because that cannot always be determined with exactitude, AL/SA uses formulary allocations when and as needed. But it is undisputed that its aim is to determine as closely as possible what actual income is derived from activities within the geographical boundaries of the taxing nation, and tax that income only. It has many flaws and imperfections, and some double taxation occurs under it, as so capably testified to by Professor Jon Bischel, but it is there as an ideal and as a working methodology. No other system is used internationally.[7] The numerous United States tax treaties however, all of which embody AL/SA, apply it to the income tax of the nations themselves and are silent with reference to taxation methods of their political subdivisions.[8]

WWCR on the other hand is a creature of California's FTB, and has been employed by other States of the United States as well, in assessing state income taxes on interstate and foreign businesses. It differs markedly from AL/SA in that at the very outset it brings into its calculation all income of the California business taxpayer, from wherever derived. Then it allocates to California its share of that income for income tax purposes by

[6]There is not to be found here, or in any other case to my knowledge, an Amicus brief by the Congress. Such a brief is of course impossible.

[7]There is an indication in the record that WWCR is used optionally by France and Canada where appropriate to prevent double taxation (RT Page 1900 et seq.)

[8]The Advisory Commission on Intergovernmental Relations recommended both ways to the Congress, for and against legislation prohibiting WWCR (Exhibits 50B (1982) and 50 (1981)).

using a three part formula, property, payroll and revenue within this State, over total property, payroll and revenue respectively, the average of which yields the fraction for allocation purposes. This method has been upheld in the interstate context, and in *Container* in the international context where the taxpayer was a United States corporate entity with foreign operations through foreign subsidiaries (whose income was included under WWCR). In this case we have a foreign (U.K.) parent (Barclays Bank, Ltd. (BBL)) of its two taxable subsidiaries, BBI and BARCAL, contributing its own income and that of its over 200 foreign subsidiaries into the formula for income taxation of BARCAL and BBI. Does this taxing scheme as so applied implicate foreign affairs? Because the tax impact falls on BBL, the foreign parent, rather than on a domestic parent as in *Container*, I conclude it does.

The evidence establishes that the AL/SA concept is universally used and favored while WWCR is everywhere disliked except as to some States of the United States. It is this foreign view of WWCR as here applied[9] that causes it to implicate foreign commerce. It is of no moment that such a view might be erroneous or even that WWCR might be a better and more efficient method academically; what matters is the international perception of WWCR as an arbitrary, unfair, and predatory measure of income taxation. The evidence shows that it is so perceived. The very fact that at the outset of WWCR's application California reaches out beyond American territorial borders to include income of Foreign Corporations wholly uninvolved with California, generates a spontaneous conclusion that foreign commerce is being taxed. The first and very prompt adverse reaction to it was vigorous and immediately successful, the insertion of 9(4) into the 1975 UK-US treaty, negotiated and executed by the Executive. The next reactions were after the reservation of 9(4) in the Senate ratification. A 1979 trip to Washington by Michael John Grylls, Member of Parliament, was made to request relief from federal officials. By 1980, the Demarches from the European

[9]Henceforth, unless otherwise noted, the abbreviation "WWCR" shall mean the method as applied in this case, i.e., a foreign parent case.

Economic Community started to arrive. They, along with other forms of diplomatic communication, showered the Executive with protests over California's WWCR and its departure from the international standard. The British Prime Minister spoke directly to the President about it. The President on October 26, 1983 established the "Working Group" to work on and suggest means of solution of this international problem — the Group reported in 1984, recommending inter-alia an end to WWCR. The UK in its Finance Act of 1985, enacted but did not implement a form of retaliation which had some effect on dividend policies of American companies operating in Britain. Finally, California went to a Water's Edge solution (Exhibit 55), thereby alleviating much of the international outcry. Disruption and embarrassment to the federal government necessarily resulted.

B. *THE SUPREMACY CLAUSE (PRE-EMPTION)*

There is no pre-emption here, not in the sense in which Plaintiffs assert it. The *Hines v. Davidowitz* (1941) 312 U.S. 52, 62 type of pre-emption specifically referred to by Plaintiffs (POB Page 42-43) exists in circumstances in which the nature of the State action affecting foreign affairs is so much in obvious conflict with the Constitution's insistence on federal involvement only, that the Constitution in and of itself has "pre-empted" the action. After so stating the rule, Plaintiffs go on to argue its existence by referring to the federal position on AL/SA and to claimed Congressional pre-emptive action (POB Page 43-50).

As heretofore indicated, I find no Congressional expression either way on this subject. Moreover that issue is disposed of by the *Container* case, for it found no Congressional expression of policy inconsistent with WWCR; nor did it find any such policy consistent with it. As to what might be termed "inherent pre-emption" of the *Davidowitz* or *Bethelem Steel* style, I find it present *in the specific context of this case*, a foreign multinational parent whose local subsidiary is taxed by WWCR. Discussion on this point will however be deferred to the next heading where it more appropriately belongs. It is my firm belief that the second of the two additional *Japan Line* tests for commerce (need for federal uniformity) is the equivalent of inherent pre-emption. The

latter also includes the so-called "Dormant Commerce Clause" analysis.

C. *WWCR'S BURDEN ON FOREIGN COMMERCE*

The second of the two additional *Japan Line* tests forbids a state tax on instrumentalities of foreign commerce, which as above stated includes by analogy, and applies to, corporations. I conclude from the evidence before me that in this case, in which the burden of the state tax falls ultimately upon a foreign parent of the taxed subsidiary, federal uniformity is essential. If California may permissibly impose this burden, so may every other state where business is conducted; and with variations, such that international chaos in the form of confusion, dissension, offensiveness, embarrassment, and retaliation are likely to result.

This case factually demonstrates as extreme an example of predictable international consequences stemming from a local tax as can be conceived. BBL, the UK corporate parent, in 1977 owned over 220 subsidiaries (including subsidiaries of subsidiaries) throughout the world, of which two only were incorporated in the United States (Barclays Bank of New York [BBNY] and BARCAL). One other only, BBI, a UK company, also did business in the United States. BARCAL was a subsidiary of BBI, along with BBNY and over 70 others operating in some 34 nations and territories outside the UK. BBL operated in some 60 nations, including those in which BBI and its subsidiaries operated. The percentage of total unitary income of the Barclays corporate network attributed by the FTB to California (both BARCAL and BBI) for 1977 was less than one and one-half (1.5%). Yet the 98.5% of the Barclay's Group income having its source outside the United States (except for the insignificant, relatively speaking, income of BBNY — See Exhibit 52R) was included in the pot from which California's 1977 income tax was to be measured, and thereby raised the tax by $154,098.00. We may say what we will about how it tends to average out over the years, how it is a relatively inconsequential sum in the overall Barclay's financial scheme, how it is no worse in actuality than AL/SA, and the like; but we cannot avoid a justifiable reaction by BBL, steeped as it is in the AL/SA tradition, of outrage. The

ensuing similar reaction of the UK, one of America's closest trading partners, is not only understandable but highly empathetic. Diplomatic consequences in the form of protests, negotiations, treaties, Executive and Congressional activities, retaliatory legislation, etc. followed, all but the last joined in by a multitude of other foreign trading partners. The record is full of examples of how the income taxation method of one state (California) has caused an inordinate amount of international furor. This is an area in which the federal government should be speaking with one voice; its foreign affairs are "implicated" by California's WWCR.

Let me stress that while we have empirical evidence of adverse international reaction, none was needed for the one voice principle to apply. Given the background up to 1977 of AL/SA and the custom of nations, given the nature of WWCR, given the addition to *Container's* factual setting of the fact that the tax burden falls on a foreign multiple parent corporation, the impact on foreign affairs was inevitable. And it was sufficiently unique and substantial to require uniformity of action in dealing with it.

FTB argues that the foreign brou-ha-ha was contrived, orchestrated by the UK alone so as to bring before this court the very evidence presented at the trial, including a disingenuous piece of "retaliatory" legislation that does not retaliate. We are of course aware that British lawyers can read and interpret *Japan Line*, *Container*, and any other Supreme Court case as well as we; and action can be taken accordingly. So without accepting the metaphors, I can accept the obvious fact that Britain took the lead in initiating the outcry and causing others to join in it (the EEC for example). But how else is foreign reaction generated? Someone must begin the outcry, and inevitably and understandably will cause others to join in it. The foreign reaction was and is no less genuine because Britain brought it about. As to the British legislation, it is indeed retaliatory if effectuated by "laying an order" in the British parliament, which has not yet been done. But such retaliation was not at all beyond possibility and likelihood up to 1986, when California went to Water's Edge. In that regard I am mindful of our own government's recent imposition of tariffs on certain Japanese imports, after endless frustrating efforts to obtain from Japan voluntary alleviation of what we perceived as

unfair Japanese trade practices. That action was very real, and against one of our closest trading partners, much like Britain. There was no frivolity associated with Clause 27 of the 1985 Finance Act.

In dealing with the federal uniformity test, *Container* posited the judicial lack of competence "to determine precisely when foreign nations will be offended by particular acts, and even less competence in deciding how to balance a particular risk of retaliation against the sovereign right of the United States as a whole to let the States tax as they please. The best we can do . . . is to attempt to develop objective standards that reflect very general observations about the imperatives of international trade and international relations." (463 U.S. at 194). One difference here is that we do have considerable evidence, which the *Container* Court did not have, of actually offended foreign nations and why WWCR offends them, enough to compel a finding of such offense. But in addition I have developed an objective standard about the imperatives of international trade and relations. That standard is that where a foreign multinational's non-domestic income is included in a formula for attribution of income taxable by a State of the United States in which that entity does business through a branch or subsidiary, given the custom of nations as to AL/SA, foreign nations will be offended, our federal government will be assailed by foreign protests, the possibility of justifiable retaliation is very real, and a need for federal uniformity exists.

* * *

The first of the two additional requirements to sustain a tax on foreign instrumentalities of commerce is "the enhanced risk of double taxation". The emphasis of this test is not on foreign reaction so much as on the more elusive and academic question of double or multiple tax.

There is a definite risk of, as well as actual double taxation here, but it is not inevitable as required by *Container*. While it plays a role in my ruling regarding federal uniformity, the *Container* holding prevents its application to the first test. All the same aspects of double taxation involved here were involved in

Container, although I agree with Plaintiffs that in this foreign multi-national context they are more aggravated. But all of them were essentially considered and rejected in *Container* (463 U.S. at 189-193). The only one that gives me pause is the automatic "asymmetry" which I find exists here but did not exist in *Container* (a domestic corporation using foreign subsidiaries to do business in foreign countries is not subject to WWCR); but I note that *Container* discusses it under the rubric of the second test, federal uniformity in foreign affairs (463 U.S. at 194-195), as does *Japan Line*, (441 U.S. at 452-453). Under that test, automatic asymmetry is one of the by-products of WWCR upon which I relied in finding WWCR unconstitutional as here applied.[10] But the automatic asymmetry factor is not a consideration in the multiple taxation test. I am bound to follow Supreme Court precedent. To keep faith with *Container's* precedent I conclude that WWCR passes the first test.

D. *WWCR'S ALLEGED DISCRIMINATION AGAINST FOREIGN COMMERCE*

There is defacto discrimination against Foreign Commerce in the context of this case. I find credible the evidence which shows that a foreign based multi-national does not have readily available to it the necessary financial accountings from many of its foreign subsidiaries to enable it to comply with WWCR's requirements and concurrently take advantage of certain benefits available under California tax law. Tax accounting and financial accounting are admittedly different; one does not and should not normally use the accounting appropriate to an annual shareholder's report to prepare and file an income tax return, in California or elsewhere. There are United States GAAP (Generally Accepted Accounting Principles), United Kingdom GAAP, and other systems, varying to greater or lesser degrees from nation to nation. There are developed nations and developing nations, with different needs and different accounting methods and procedures. Books of for-

[10]It is not feasible for me in this Intended Decision to refer to every specific item of evidence which supports a finding or conclusion. Many Exhibits and much testimony not specifically enumerated support the various parts of this determination.

eign subsidiaries of BBL (and BBI) are kept in accordance with accounting procedures in the country of incorporation or in which they do business. The Internal Revenue Laws and Regulations of the federal government contain specific rules affecting income taxation of foreign multi-nationals, but they include only income whose source is within the territorial borders of the fifty states, and such income is determined under AL/SA; thus the income of foreign subsidiaries is ignored. Foreign parent corporations which do business in California must under WWCR report to FTB the income of their subsidiaries. But that income as reported to the parent sans WWCR is reported and accepted as prepared by and for each subsidiary. Nothing further by way of adjustment or information is needed nor is appropriate for the parent from those foreign subsidiaries to enable the parent to file tax returns in its own country and with the IRS. But when it becomes necessary for the foreign parent to report its foreign subsidiary's income to the taxable entity for inclusion in WWCR, the readily available financial information does not fit. There are adjustments that must be made (e.g., translation of currency, adjustment of fixed assets, leased assets and bad debts, conversion to GAAP, etc.) and others that can and properly should be made to take advantage of FTB's authorized deductions and other benefits[11] (e.g. depreciation allowances). Such information is not maintained on a current basis by those foreign subsidiaries and hence is not readily available and sometimes is totally unavailable. FTB's experts agree that literal compliance with WWCR is impossible, because no foreign multi-national maintains appropriate accounting books for it. The sole reason for changing accounting methodology to make it regularly available is to file properly under WWCR. The cost to reconstruct such information for past years is prohibitive; the cost to set up and maintain a system to obtain it currently by changing the accounting methodology in each appropriate foreign subsidiary is huge, over $5,000,000.00 to establish and over $2,000,000.00 annually to maintain. Such amounts are

[11]There is no point in turning this into an accounting nightmare by further enumeration of the accounting changes and potential changes involved. But they are there.

conceded by FTB to be unreasonable if true; but they are claimed unnecessary for proper compliance. I find them so necessary.

Plaintiffs claim that this amounts to discrimination against foreign commerce because only a foreign multi-national is put in this position of either foregoing available tax reporting benefits (including the use of approximations — see infra) or spending inordinate sums to be in a position to file properly; or of course to discontinue business in California. Correlatively, competitive businesses not conducting business in other nations, including domestic parent corporations with foreign subsidiaries,[12] do not have this added burden, and hence are given an advantage by FTB. This is assertedly "economic protectionism". The claim is valid; there is a less intrusive and less burdensome alternative, Water's Edge; WWCR does unfairly and systematically discriminate against foreign multi-nationals and thereby unduly burdens foreign commerce. (*Boston Stock Exch. v. State Tax Comm'n* (1977) 429 U.S. 318; *Hunt v. Wash. State Apple Advertising Comm'n* (1977) 432 U.S. 333; *H. P. Hood & Sons v. Dumond* (1949) 336 U.S. 525.)

FTB counters this claim first by maintaining that dollar cost of compliance as presented by two Plaintiff witnesses is not credible; I have more than allowed for possible exaggeration, even though FTB presented essentially no evidence on the point. FTB's second defense is grounded on Cal. Adm. Code, Title 18, Section 25137-6, pursuant to which it claims there are alternatives to strict compliance with WWCR requirements. The regulation does specify that no adjustment to income is required unless it is material. It also allows use of reasonable approximations, considering the expense and effort required to obtain the necessary information for compliance. It also allows for advance determinations of what the taxpayer proposes to do. All these are illusory to the taxpayer, for neither binds the FTB to accept anything; it has

[12]Though domestic parents of foreign subsidiaries (See *Container*) have this same dilemma as to their foreign operations, they do not have it as a result of WWCR. They have it because federal income tax laws require it. Those same laws do not require it as to foreign subsidiaries of foreign parents.

the complete authority to make the ultimate decision as to whether an item is material, as to whether or not an approximation is reasonable and will be accepted, and whether an advance determination will be made and in what way. There is no genuine alleviation of the taxpayer's problem by these techniques. There are certain situations in any type of taxing case and with any taxing authority, in which approximations must be resorted to. But taxation by approximation to avoid an unduly onerous dollar cost of compliance burden is not a cure.

E. WWCR AS VIOLATIVE OF DUE PROCESS

Plaintiffs claim that because an element of the WWCR calls for materiality, reasonable approximations, and advance determinations, all at the unfettered discretion of FTB, with no guidelines, there is a violation of the due process clauses (both U.S. and California) insofar as the tax relates to a foreign multinational.

The WWCR regulation is not on its face uncertain, nor does the approximation segment make it uncertain. Its taxing rules are sufficiently clear and understandable to satisfy due process. The discretionary advance determination, reasonable approximation, and materiality rules (materiality does not really belong in this thought —it is inherent and essential in every tax scheme) are only there to the extent a taxpayer seeks to avail himself of them. They are not imposed willy-nilly.

What does constitute a due process violation is the fact that all witnesses agreed that with customarily and currently available accounting data, literal compliance with WWCR requirements is impossible for foreign multi-nationals such as Plaintiffs, and the only way to "comply" is by supplication and negotiation (absent an unduly burdensome cost of compliance). There is no reasonable certainty and no judicial reason to believe that whatever the taxpayer considers reasonable or material will be so treated by the FTB. I certainly would not expect this type of pre-established capitulation from the fine and dedicated public servants (Ben Miller, Eric Coffill, Stephen Wetzel, etc.) whose efforts in the

State's behalf came to my attention at the trial. Bureaucratic mistakes and excesses are always possible.[13]

Thus I conclude that WWCR as applied to Plaintiffs violates due process, both federal and state. (*C.F. Chy Lung v. Freeman* (1876) 92 U.S. 275; *Grayned v. Rockford* (1972) 408 U.S. 104; *McDonnell Douglas Corp. v. Franchise Tax Bd.* (1968) 69 C2 506).

F. PLAINTIFFS' BURDEN OF PROOF

FTB claims that Plaintiffs have a burden to establish not only that the amount of tax assessed was improper but what the proper amount should be, citing *People v. Schwartz* (1947) 31 Cal. 2d. 59. I have no quarrel with the rule, but it does not apply here. Since the WWCR method has been found invalid, the additional assessment imposed because of it was improper; correlatively the amount originally paid is the correct amount, any excess over that having resulted from the invalid method. As to the dollar amount to be refunded by FTB, including interest, the parties have stipulated to calculate and insert that amount in the judgment (Exhibit 1, Page 2).

G. CONGRESSIONAL ACTION PREVAILS OVER INCONSISTENT EXECUTIVE ACTION IN FOREIGN RELATIONS[14]

This issue has been resolved favorably to FTB (See Section IV A, supra).

H. EFFECT OF CONTAINER AND WARDAIR

FTB has relied heavily on its interpretation of these two cases. If indeed they were to be so interpreted, the judicial result would

[13]As where the FTB auditor here failed for arbitrary reasons to deduct from plaintiffs' total income (working off an annual report for lack of better information) that attributable to "associate" (less than 50% owned) companies of BBL.

[14]FTB's jurisdictional argument (DB Page 6-7) has been disposed of under Section II.

have been in FTB's favor. In the course of resolution of Plaintiffs issues as tendered I have resolved FTB's contentions partly in FTB's favor and partly otherwise.

Container did conclude that the "four usual issues" involved in state taxation of both interstate and foreign commerce resolved themselves in FTB's favor (DB Page 17-21). *Container* determined there was no expressed Congressional policy *against* WWCR, but did not address the question of whether such policy was expressed Congressionally *for* it. (DB Page 21-22). The issue was certainly there for *Container* to address, and had such policy been so found it would have ended the inquiry and avoided the need to address the two additional *Japan Line* factors. The failure to deal with that issue has led me to interpret *Container* as indicating judicially no Congressional policy either way.

Proceeding to the first additional *Japan Line* test, in its Dormant Foreign Commerce Clause analysis *Container* resolved it in favor of FTB. I respected that precedent and have followed it. *Container* did likewise regarding the second test, but it was necessarily limited to a domestic parent case, and I have found enough constitutionally significant differences in this foreign parent case to determine WWCR invalid as here applied. The great disagreement of FTB comes from its interpretation of the *Wardair* holding (DB Page 23-43) to the effect that Congressional "acquiescence" can and will establish a foreign policy. Citing five indications of such acquiescence both Executively and Congressionally (Income Tax Treaties, U.S. Model Convention and Reservations to OECD and UN Model Conventions, FCN Treaties, Senate Action Regarding 9(4), and no enactment of proposed legislation to prohibit WWCR), FTB maintains that *Wardair* compels a finding of policy by acquiescence here. Each factor was carefully considered, and I found no sufficient similarity to *Wardair* to suggest its application. *Wardair* involved an uninterrupted string of Treaties, Conventions, and legislation, before and after the tax year, with no specific disagreement or dispute either by Congress or the Executive (except for an amicus brief). Here we have no manifestation of the problem until 1972, followed by a prompt expression of Executive policy opposing state WWCR in 1975 (the Treaty), echoed by the Senate in its

actual vote count in 1978, followed by nothing of consequence thereafter from Congress and uninterrupted perseverance in its policy by the Executive. The U.S. Model Convention, like the tax treaties since 1978, does not impress me as indicative of a policy (See IV A, supra); "reservations" are just that, reservations of opinion and not themselves opinion or policy; a failure on the part of Congress to vote on a pending bill expresses nothing by way of intent and I have no evidence that Congress actively voted to defeat proposed legislation outlawing WWCR. With every respect for FTB's *Wardair* argument and the competent manner in which it was presented, I disagree.

Bass, Ratcliff & Gretton, etc. v. State Tax Comm. (1924) 266 U.S. 271, involving a unitary form of tax on foreign commerce is contended by FTB to have been confirmed by *Container* (DB Page 17, FN 10) and to be persuasive here. I cannot agree. If *Bass, Ratcliff* were considered authority for the broad proposition that WWCR is constitutionally proper as to foreign multi-nationals, *Container* would simply have cited it for that proposition and it would have ended the Court's inquiry. Instead, after citing it, the *Container* court twice expressly reserved this very question, thereby making it clear that *Bass, Ratcliff* is not precedent for FTB's contention here.

I. DORMANT FOREIGN POLICY ANALYSIS

This issue has been addressed. No double taxation proscription was found, following the precedent of *Container*, but the need for federal uniformity was found. FTB's arguments on double tax (DB Page 46-60) have been accepted or are academic. FTB's arguments on federal uniformity (DB Page 60-72) have been considered (IV A and IV C, supra), and found unpersuasive.

J. COSTS OF COMPLIANCE

FTB presents its position with reference to the legal and constitutional effect of Plaintiffs' evidence of their costs of compliance with California's WWCR regulation at DB Page 73-97. All of it has been considered and dealt with in connection with IV D, supra. There are several points made by FTB however regarding which some comment is appropriate.

FTB claims of course that Plaintiffs' alleged costs of compliance are exaggerated and not genuinely necessary. An example is given of the fact that BBI actually did undertake to file for 1977 (and prior years) on a WWCR basis, and it has many foreign subsidiaries whose income was included in the return, prepared at a very nominal charge by Price Waterhouse (DB Page 77-79). I find this unpersuasive. The return was not prepared in accordance with Regulation 25137-6, and for this reason it was rejected by FTB (along with prior similar returns). It was erroneous in that it used figures from the annual report, admittedly inaccurate for income tax purposes. Furthermore, the fact that a taxpayer complies or attempts to comply with a tax scheme he considers invalid does not prevent him from presenting fully his reasons for its claimed invalidity in later protests. I am aware of no estoppel principle that applies here. And while I have understood the point of this FTB argument I find it without merit.

FTB suggests that Plaintiffs' costs of compliance evidence is not worthy of belief because no money has yet been spent by Plaintiffs to comply (DB Page 84). This begs the question. It would be folly for a taxpayer who claims a given tax is invalid to spend millions to comply with it when he is concurrently challenging it formally by lawsuit.

Finally in response to Plaintiffs' claim that WWCR offends American policy of encouraging foreign businesses to invest in this country, FTB points to continuing success and prosperity of Plaintiffs in California (DB Page 96). FTB misapprehends the policy. The fact that a certain business is successful does not negate the propriety of its efforts to defeat actions perceived to be harmful to the policy. The policy does not encourage foreign investment just to a certain profitable point; it encourages it to a point of continuing and ever increasing profitability.

K. DUE PROCESS

No further discussion is appropriate.

L. IMPOSITION OF WATER'S EDGE

FTB's position has merit. Plaintiffs assert (POB Page 111-113) that this court should impose upon FTB the AL/SA method. This court can only act negatively, to find the WWCR method invalid as applied to Plaintiffs and other similarly situated; it cannot legislate. In their closing brief (PCB Page 81), Plaintiffs appear to retreat from this effort. In any event, the suggestion is rejected.

V

CONCLUSION

The tax as sought to be imposed here by FTB is unconstitutional. The claim for refund will be allowed.

Unless a specific request is filed by either party as in CCP Section 632 provided, this Intended Decision shall be deemed in full compliance with that Section's requirement for a Statement of Decision.

DATED: JUNE 12, 1987

GEORGE E. PARAS
George E. Paras
Judge of the Superior Court, Pro Tem

EXHIBIT 1

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SUPERIOR COURT OF THE STATE OF CALIFORNIA
COUNTY OF SACRAMENTO

BARCLAYS BANK INTERNATIONAL LTD.,
a corporation of the Country of England,
Plaintiff,
vs.
FRANCHISE TAX BOARD,
an agency of the State of California
Defendant.

BARCLAYS BANK OF CALIFORNIA
a California Corporation,
Plaintiff,
vs.
FRANCHISE TAX BOARD,
an agency of the State of California,
Defendant.

No. 32509 & No. 325061 (Consolidated for Purposes of Trial)

ENDORSED: November 3, 1986
JOYCE RUSSELL SMITH, CLERK
By Kathleen L. Burgess, Deputy

SCHEDULE I

JOINT STIPULATION OF FACTS
Trial Date 11-10-86

IT IS HEREBY STIPULATED by and between the parties, through their attorneys of record, that the following facts are agreed and undisputed. This stipulation shall not be construed as a concession by either party of the relevancy or materiality of any of the facts stipulated, and the parties reserve the right to argue the relevance, materiality or weight of any of the facts stipulated.

All documents referred to herein or specifically enumerated are compiled under separate cover, have been reviewed by counsel for the parties and their authenticity and foundational basis admitted. The documents shall be entered into evidence. Nothing contained in this stipulation shall prevent a party from introducing at trial any other or further evidence. With permission of Court, documents described in paragraphs 32, 40, and 41 hereof will be deemed admitted in evidence in entirety without physically presenting the same at trial. Either party may refer to said documents in summary form or as individual exhibits at trial or on appeal as evidence admitted at trial.

Nothing contained herein shall be construed as a waiver by any party of its right to review on appeal any question of law or fact arising in this action in the same manner and to the same extent as if the facts set forth herein had been proven in open court.

The parties will make any computations necessary for inclusion in appropriate findings after the court's decision in this matter.

This stipulation shall only apply to the above-entitled consolidated actions and to any appeals from the judgment of this Court.

FACTS

The following facts are agreed and undisputed:

1. During income year ending September 30, 1977 (hereafter referred to as income year 1977), plaintiff Barclays Bank International Limited ("BBI") was a corporation organized and existing under the laws of England and was qualified to do, and was doing, business as a banking agency in San Francisco, California.

2. During income year 1977, BBI was engaged in general retail and commercial banking, leasing, and consumer and commercial finance, directly or through subsidiaries, in approximately fifty-five (55) countries and territories.

3. During income year 1977, BBI itself operated through banking agencies or branches in approximately thirty-three (33) nations or territories outside the United Kingdom. BBI operated in the United States through branches or agencies located in the states of Georgia, Massachusetts, Illinois, New York and California.

4. During income year 1977, BBI owned more than fifty percent (50%) of over seventy (70) subsidiaries which operated in approximately thirty-four (34) nations or territories outside the United Kingdom.

5. During income year 1977, BBI owned banking subsidiaries which were organized and operated in the United States, including Barclays Bank of New York ("BBNY") and Barclays Bank of California ("Barcal").

6. During income year 1977, BBI was a wholly-owned subsidiary of Barclays Bank Limited ("BBL"), a United Kingdom clearing bank, organized and existing under the laws of England.

7. During the income year 1977, BBL owned, directly or indirectly, in addition to BBI and its subsidiaries, over one hundred forty (140) subsidiaries, none of which was incorporated under the laws of the United States or any political subdivision or territory thereof, and none of which operated in California or in the United States.

8. During the income year 1977, BBL and all subsidiaries of which it owned more than fifty percent (50%) of the stock, directly or indirectly, including BBI and Barcal, operated in over sixty countries or territories. A list of these subsidiaries showing country of incorporation and equity ownership is attached as trial Exhibit 8. BBL and such subsidiaries will be referred to as the Barclays Group and individually or collectively as a member or members of the Barclays Group, respectively.

9. During income year 1977, Barcal, a California banking corporation and a wholly-owned subsidiary of BBI, was engaged in the commercial banking business in the State of California where it operated through forty-nine (49) branch banking offices.

10. On January 1, 1985, pursuant to the United Kingdom's Companies Act and the Barclays Bank Act 1984, BBL was merged with BBI under the name Barclays Bank PLC, and a holding company, Barclays PLC, became the parent of Barclays Bank PLC.

11. Defendant Franchise Tax Board ("FTB") is an agency of the State of California. The FTB is vested with the power and duty to administer the Bank and Corporation Franchise Tax Law of the State of California.

12. For the income year 1977, BBI prepared and filed a California Bank and Financial Tax Return and paid a total tax liability to the Franchise Tax Board of $14,447.54.

13. For the income year 1977, Barcal prepared and filed a California Bank and Financial Tax Return and paid a total tax liability to the FTB of $541,276.49.

14. The FTB conducted an audit of the California tax returns of BBI and Barcal for the income year 1977. Upon audit the FTB determined that BBI and Barcal were part of a worldwide unitary business conducted by all members of the Barclays Group.

15. Based upon its determination that BBI and Barcal were a part of a worldwide unitary business conducted by all the members of the Barclays Group, the FTB issued Notices of Additional Tax Proposed to be Assessed (hereafter Notices) as follows: to BBI in the amount of $4,076.02 for a total tax for the income year of 1977 of $18,523.56; to Barcal in the amount of $254,699.45 for a total tax for the income year of 1977 of $795,975.94.

16. The FTB's calculation of BBI's and Barcal's California tax liability was set forth in Schedule 1 of the attachment to the Notices as follows:

BUSINESS INCOME:		
INCOME BEFORE TAXES, SECURITIES GAINS/LOSSES, MINORITY INTERESTS AND EXTRAORDINARY ITEMS	pg. 10 Pros.	£270,300,000
SECURITIES GAINS/(LOSSES)	pg. 30 Bbl A/R	(2,400,000)
EXTRAORDINARY ITEMS	pg. 23 Bbl A/R	300,000
TOTAL POUND STERLING............		268,200,000
CONVERSION RATE..................		1.7025
BUSINESS INCOME — IN U.S. DOLLARS		$456,610,500

	BBI	Barcal
APPORTION TO CALIFORNIA..............	$149,083	$6,406,245
TAX RATE	.12425	.12425
TAX	$ 18,524	$ 795,976
TAX PREVIOUSLY ASSESSED..............	$ 14,448	$ 541,276
ADDITIONAL TAX	$ 4,076	$ 254,700

17. The reference to "page 10 PROS" is a reference to page 10 of the Preliminary Prospectus dated March 31, 1981 $125,000,000 Barclays North American Capital Corporation % Guaranteed Capital Notes due 2006. The references to pages 30 and 23 respectively were references to the BBL Reports and Accounts for 1977. The reference to "TAX PREVIOUSLY ASSESSED" means the tax paid by BBI and Barcal on filing, net of certain refunds.

18. BBI and Barcal filed protests of the proposed assessments in 1982, which protests were timely. BBI had originally filed its tax returns for the income year 1977 on the basis that it was part of a unitary business composed of itself and its subsidiaries. BBI protested the tax on the basis, *inter alia*, that the correct method upon which to compute its tax liability was separate entity/arm's length accounting.

19. Barcal timely filed a protest of the proposed assessment. It had originally filed its tax returns for the income year 1977 on a separate entity/arm's length accounting basis, and protested the

additional assessment on the basis, *inter alia*, that the correct method upon which to compute its tax was separate entity/arm's length accounting.

20. On May 21, 1984, BBI paid the additional proposed tax of $4,076.02 and BBI's administrative protest was converted by operation of law into a claim for refund of taxes. It is upon this claim that the instant litigation is based.

21. On October 31, 1983, Barcal paid additional proposed tax of $250,000.00 and Barcal's protest was converted by operation of law into a claim for refund of taxes. It is upon this claim that the instant litigation is based.

22. After the issuance by the FTB of the Notices and the filing by BBI and Barcal of the protest, the FTB adjusted the audit schedules as follows:

BUSINESS INCOME PER AUDIT	£268,200,000
LESS: INCOME OF ASSOCIATED COMPANIES	(39,700,000)
ADD: DIVIDENDS FROM ASSOCIATED COMPANIES	5,105,000
ANZ GROUP DIVIDEND	735,000
ADD: ACCOUNTING METHOD CHANGE (AMORTIZATION — FROM AGREEMENT PRIOR YRS)	1,429,000
ADD: EXTRAORDINARY INCOME, AMOUNT THAT HAD BEEN EXCLUDED (ATTRIBUTABLE TO MINORITY SHAREHOLDERS)	100,000
REVISED BUSINESS INCOME — POUND STERLING	£235,869,000
CONVERSION RATE	1.7025
REVISED BUSINESS INCOME — U.S. $	$401,566,973
REVISED APPORTIONMENT % — BBI	.0003232
INCOME APPORTIONED TO CALIFORNIA	129,786
TAX RATE	12.425%
TOTAL REVISED TAX	16,126
PREVIOUSLY ASSESSED	14,448
ADDITIONAL TAX — REVISED BBI	$ 1,678
REVISED APPORTIONMENT % — BARCAL	.0139032
INCOME APPORTIONED TO CALIFORNIA	5,583,066
TAX RATE	12.425%
TOTAL REVISED TAX	693,696
PREVIOUSLY ASSESSED	541,276
ADDITIONAL TAX — REVISED BARCAL	$ 152,420

23. Board issued Notices of Action on Taxpayer's Protest to BBI and Barcal on February 15, 1985, for the amounts set forth in paragraph 22.

24. The payment of $250,000.00 made by Barcal on October 31, 1983 was credited by the Board against Barcal's additional tax as revised of $152,419.01. The remaining amount was credited to the interest owing on such liability and on April 19, 1985 an additional payment of $25,670.82 with respect to the interest owing on the $152,419.01 tax was made and credited to Barcal's account. The total amount of refund being sought by Barcal in this case is tax in the amount of $152,419.01 and interest of $123,251.81.

25. Payment of $4,076.02 made by BBI on May 21, 1984 was credited against the revised tax of $1,678.46 and interest on such amounts of $1,505.06. The remaining amount of $892.50 was subsequently refunded to BBI with interest as provided by law. These additional payments of $1,678.46 of tax and $1,505.06 of interest are the amounts for which BBI is seeking a refund in this action.

26. The FTB, through its attorney Marvin J. Halpern ("Halpern"), and BBI and Barcal, through their attorney Joanne M. Garvey ("Garvey"), have corresponded regarding, *inter alia*, plaintiffs' respective Section 25137 petitions for the income years ending September 30, 1977, 1978 and 1979 and December 1, 1979. In addition members of the FTB or the FTB staff have drafted certain documents concerning Section 25137 petitions. These documents include:

26a. Letter from Garvey to Halpern dated May 18, 1984.

26b. Letter from H. Barry Berlin to California Franchise Tax Board, dated May 22, 1984.

26c. Photocopies of checks numbers 45007-45009 of BBI, dated May 21, 1984 drawn on Barclays Bank International Limited account payable to the Franchise Tax Board.

26d. Letter from Halpern to Garvey dated June 22, 1984.

26e. Letter from Garvey to Halpern dated June 28, 1984.

26f. Letter from Halpern to Garvey dated July 24, 1984.

26g. Letter from Garvey to Halpern dated September 11, 1984.

26h. Letter (via Telex) from Garvey to Halpern dated November 9, 1984.

26i. Letter from Halpern to Garvey dated January 28, 1985.

26j. FTB's Notice of Action on Taxpayer's Protest to Barcal, dated February 15, 1985.

26k. FTB's Notice of Action on Taxpayer's Protest to BBI, dated February 15, 1985.

26l. Letter from Garvey to Halpern, dated June 28, 1985.

26m. Letter from Halpern to Garvey dated January 8, 1986.

26n. Exhibit No. 3 to Marvin Halpern's deposition taken January 16-17, 1986, entitled "Statement of the Franchise Tax Board Pertaining to Section 25137 Petitions."

26o. Memorandum from Martin Huff to Walter Harvey, concerning "Petitions for Relief under Section 25137 Bank and Corporation Tax Law," dated June 23, 1977.

26p. Memorandum from Benjamin F. Miller to Martin Huff, Executive Officer, concerning "Meeting with Dennis Amundsun, Director Department for Economic and Business Development," dated March 21, 1978.

26q. Memorandum from Marvin J. Halpern to Glenn L. Rigby dated July 25, 1984.

26r. Letter from R.E. Gilbert to the California Franchise Tax Board, dated October 31, 1983.

27. For purposes of this litigation only, BBI and Barcal agree that for income year 1977 they were members of a worldwide unitary business within the meaning of Revenue and Taxation Code Section 25101, *et. seq.*, composed of the members of the Barclays Group.

28. On September 23, 1983, United States Secretary of Treasury, Donald T. Regan, announced the establishment of the Worldwide Unitary Taxation Working Group ("Working Group").

29. The Final Report of the Worldwide Unitary Taxation Working Group, Chairman's Report and Supplemental Views, August 1984, was transmitted to the President of the United States on August 31, 1984.

30. Among those testifying before, or submitting reports to, the Working Group or the Task Force of the Working Group were:

30a. Statement of the United Kingdom before the United States Treasury Working Group on Worldwide Unitary Taxation.

30b. Presentation by Mr. Barry Pollard, Inland Revenue, on United Kingdom Experience of Operating the Arms Length Principle With Special Reference to Transfer Pricing Enquiries.

30c. Statement of Canada before the United States Worldwide Unitary Taxation Working Group.

30d. Submission of the Australian Government to the U.S. Task Force on Unitary Taxation, dated January 4, 1984.

31. Trial Exhibit 31 to this stipulation is a true and accurate summary chart of the country of incorporation and the financial operating profit in pounds sterling of the members of the Barclays Group as set forth in the business records of the companies comprising the Group, prepared in the ordinary course of business and used, among other things, for the preparation of the Reports and Accounts of the Barclays Group.

32. Foreign governments, on their own behalf or as the representatives of official governmental bodies such as the European Economic Community (EEC), have sent communications (collectively trial Exhibit 32) to the United States government and to the several states of the United States, including California, expressing objections to use by the states, including California, of the worldwide combined reporting unitary method of state taxation. Some of these are:

32a. Letter from Hon. Nigel Lawson, Chancellor of the Exchequer for the United Kingdom to the United States Secretary of the Treasury, Hon. Donald T. Regan, dated July 12, 1983.

32b. Demarche from Italy, as President of the EEC, on behalf of the Nine European Economic Community Governments to the Department of State, Washington, D.C., dated March 19, 1980.

32c. Demarche No. 51 from the United Kingdom Embassy to the Department of State, Washington, D.C., dated March 25, 1980.

32d. Demarche No. 211 from the United Kingdom, as President of the EEC, on behalf of the Ten European Economic Community Governments to the Department of State, Washington, D.C., dated October 30, 1981.

32e. Demarche No. 692 from the Embassy of Canada to the Department of State, Washington, D.C., dated December 22, 1981.

32f. Demarche No. 83 from the United Kingdom Embassy to the Department of State, Washington, D.C., dated May 18, 1982.

32g. Demarche No. 283 from the Embassy of Canada to the Department of State, Washington, D.C., dated June 14, 1982.

32h. Demarche from the Government of Belgium as President of the EEC, on behalf of the ten European Economic Community Governments to the Department of State, Washington, D.C., dated June 29, 1982.

32i. Demarche from Greece, as President of the EEC, on behalf of the ten European Economic Community Governments to the Department of State, Washington, D.C., dated August 1, 1983.

32j. Demarche No. 481 from the Embassy of Canada to the Department of State, Washington, D.C., dated September 28, 1983.

32k. Demarche No. 383/83 from the Embassy of Australia to the Department of State, Washington, D.C., dated November 7, 1983.

32l. Demarche No. 461.20-LJ/hu from the Embassy of Switzerland to the Department of State, Washington, D.C., dated November 15, 1983.

32m. Demarche from the Federal Republic of Germany to the Department of State, Washington, D.C., dated November 28, 1983.

32n. Demarche No. EA-14533 from the Embassy of the Kingdom of the Netherlands to the Department of State, Washington, D.C., dated December 21, 1983.

32o. Demarche from the Embassy of Belgium on behalf of the ten European Economic Community Governments, the European Commission and the Embassies of Australia, Canada, Japan and Switzerland to the Department of State, Washington, D.C., dated January 25, 1984.

32p. Demarche from the Embassy of Belgium to the Department of State, Washington, D.C., dated January 25, 1984.

32q. Demarche No. 634 from the Embassy of Canada to the Department of State, Washington, D.C., dated February 27, 1984.

32r. Aide-memoire from the Government of Japan to the United States Government dated June 6, 1984.

32s. Official correspondence from the Hon. Marc Lalonde, Minister of Finance for Canada to the United States Secretary of the Treasury, Hon. Donald T. Regan, dated August 11, 1983.

32t. Letter from W. Wachtmeister, Swedish Ambassador to the United States, and the Governments of Australia, Austria, Belgium, Canada, Denmark, Finland, France, the Federal Republic of Germany, Greece, Ireland, Italy, Japan, Luxembourg, Norway, the Kingdom of the Netherlands, Sweden, Switzerland, the United Kingdom and the Commission of the European Communities to the Hon. Robert Bangter, Governor of the State of Utah, dated February 15, 1985.

32u. Letter from J.L. Beaven, United Kingdom Consul-General to the United States, to the Hon. Willie L. Brown, Jr., Speaker of the California Assembly, dated June 18, 1984.

32v. Letter from W. Wachtmeister, Swedish Ambassador to the United States, and the Governments of Australia, Austria, Belgium, Canada, Denmark, Finland, France, the Federal Republic of Germany, Greece, Ireland, Italy, Japan, Luxembourg, Norway, Sweden, Switzerland, the United Kingdom and the Commission of the European Communities to the Honorable Richard D. Lamm, Governor of the State of Colorado, dated January 25, 1985.

32w. Letter from W. Wachtmeister, Swedish Ambassador to the United States, and the Governments of Australia, Austria, Belgium, Canada, Denmark, Finland, France, the Federal Republic of Germany, Greece, Ireland, Italy, Japan, Luxembourg, Norway, the Kingdom of the Netherlands, Sweden, Switzerland, the United Kingdom and the Commission of the European Communities to the Hon. George A. Sinner, Governor of the State of North Dakota, dated March 18, 1985.

32x. Letter from Jacques S. Roy of the Embassy of Canada to the Hon. Robert Graham, Governor of the State of Florida, dated May 30, 1984.

32y. Letter from J. Raoul Schoumaker of the Embassy of Belgium and the Governments of Australia, Austria, Belgium, Canada, Denmark, Finland, France, the Federal Republic of Germany, Greece, Ireland, Italy, Japan, Luxembourg, the Kingdom of the Netherlands, Sweden, Switzerland, the United Kingdom and the Commission of the European Communities to the Hon. Robert Graham, Governor of the State of Florida, dated November 28, 1984.

32z. Letter from H.G. Walsh, Counsellor (Economic) British Embassy Washington, D.C. to the Honorable Edmund G. Brown, Governor of the State of California, dated October 30, 1981.

32aa. Letter from Christopher E. F. Davis, Consul Canadian Consulate, San Francisco, California to Gerald Goldberg, Executive Officer Franchise Tax Board of California, dated January 26, 1984.

32bb. Letter from J. L. Beaven, Her Majesty's Consul-General to the Honorable George Deukmejian, Governor of California, dated June 21, 1983.

32cc. Letter from the United Kingdom Chancellor of the Exchequer to the Secretary of the United States Treasury dated June 20, 1985.

32dd. Undated Memorandum from the Netherlands Government to the Governor of California.

32ee. Letter from the Hon. Pierre Trudeau to Hon. Ronald Reagan, President of the United States, dated September 24, 1983.

33. The following documents pertaining to treaties of Friendship, Commerce, and Navigation were provided to Benjamin F. Miller, Counsel for Multistate Tax Affairs for the FTB, by the Department of State:

33a. The first page and pages 15 and 16 of a Memorandum to the Embassy at Chungking for Use in Negotiating Treaty of Friendship, Commerce and Navigation. These pages, constituting the only pages received of the above-mentioned document by the FTB were enclosures to the letter dated August 22, 1980 referred to in paragraph 33(c).

33b. The first page and pages 16 through 19 of a Memorandum to the American Embassy at Rio de Janeiro for Use in Negotiating Treaty of Friendship, Commerce and Navigation Between the United States and Brazil. These pages, constituting the only pages received of the above-mentioned document by the FTB, were enclosures to the letter dated August 22, 1980 referred to in paragraph 33(c).

33c. The cover page and pages ii, 19, 20, 21, 202 and 203 of a preliminary draft of a study entitled *Standard Draft Treaty of Friendship, Commerce and Navigation* prepared under contract to the Department of State by Charles H. Sullivan. These pages, constituting the only pages received of the above-mentioned document by the FTB, were enclosures to a letter dated August 22, 1980 and signed by Stuart E. Benson, Acting Assistant Legal Advisor, Office of the Legal Advisor, Department of State, addressed to D. R. Milton, Vice President Tax, Shell Oil Company, Houston, Texas, carbon copy to Benjamin F. Miller, Franchise Tax Board, State of California.

33d. Pages 13a through 15 of Annotated Draft FCN for Portugal prepared by Herman Walker. These pages, constituting the only pages received of the above-mentioned document by the FTB, were enclosures to the letter dated August 22, 1980 referred to in paragraph 33(c).

33e. HICOG Bonn Despatch No. 2255 of February 17, 1954, pages 1 through 5 inclusive, with two page attachment No. 1868. These documents were enclosures to the letter dated August 22, 1980 referred to in paragraph 33(c).

33f. A three page Airgram of the Department of State dated July 3, 1983 concerning FCN Treaty with the Netherlands, and replying to Embassy dispatch 1472. This document was an enclosure to a letter dated August 28, 1980, from Stuart E. Bensen, Acting Assistant, Legal Advisor, Office of the Legal Advisor, addressed to D.R. Milton, Vice President of Tax, Shell Oil Company, Houston, Texas, carbon copy to Benjamin F. Miller, Franchise Tax Board.

33g. Letter dated February 11, 1981 from Theodore W. Kassinger, Attorney Advisor, Office of Assistant Legal Advisor for Economic and Business Affairs, Department of State.

34. On July 9-10, 1985, the Parliament of the United Kingdom debated and unanimously passed legislation in Clause 27 of the Finance Act of 1985. The proceedings of Parliament are truly and accurately reported in the House of Commons Official Report, Parliamentary Debates (Hansard), Wednesday 10 July 1985, Volume 82, No. 152.

35. The United Kingdom's Finance Act of 1985.

36. There have been discussions and debates in, and documents presented to, the United States Congress concerning the use by the states of worldwide combined reporting, some of which are reported as follows:

36a. Statement of Senators Wilson and Mathias and Statement by the President of the United States in support of the Unitary Tax Repealer Act. 131 Cong. Rec. 17975-17978 (1985).

36b. Executive Session and Statement of Senator Hiyakawa regarding consideration of the United Kingdom-United States treaties. 125 Cong. Rec. 17427-17435, 17796 (1979).

36c. Executive session regarding consideration of tax convention with the United Kingdom. 124 Cong. Rec. 18402-18430 (1978).

36d. Executive session continued regarding consideration of tax convention with the United Kingdom. 124 Cong. Rec. 18651-18670, 18709-18712 and 19076-19078 (1978).

36e. Introduction of H.R. 3980 by Hon. John J. Duncan as reported in the Congressional Record of December 19, 1985 on pages E5754 and 5755 (extension of remarks).

37. Various committees of the United States Congress have held hearings on the issues of state taxation, including the use by the states of worldwide combined reporting, which committees' proceedings, some of which have been transcribed or which committees have issued reports, as follows:

37a. Committee on Ways and Means, 95th Congress, 1st Sess., Recommendations of the Task Force on Foreign Source Income (Comm. Print 1977).

37b. Senate Committee on Foreign Relations, Third Protocol to the 1975 Income Tax Convention With the United Kingdom of Great Britain, and Northern Ireland, as Amended, S. Doc. No. 5, 96th Congress, 1st Sess. (1979).

37c. Tax Treaties With the United Kingdom, the Republic of Korea, and the Republic of the Philippines, 1977: Hearings Before the Senate Committee on Foreign Relations, 96th Congress, 1st Sess. (1977).

37d. State Taxation of Foreign Source Income, 1980: Hearings on H.R. 5076 Before the House of Representatives Committee on Ways and Means, 86th Congress, 2d Sess. (1980).

37e. State Taxation of Interstate Commerce and Worldwide Corporate Income, 1980: Hearings on S. 983 and S. 1688 Before the Subcomm. on Taxation and Debt Management Generally of the Senate Comm. on Finance, 96th Congress, 2d Sess. (1980).

37f. Unitary Taxation, 1984: Hearings before the Subcomm. on International Economic Policy of the Senate Foreign Relations Comm., 98th Cong., 2d Sess. (1984).

37g. Interstate Taxation, S. 2173: Hearings before the Senate Committee on the Judiciary, 95th Cong., 1st and 2nd Sess. (1977-1978).

38. Various proposed Legislative bills have been introduced in the United States Congress that would, among other things, affect the states' use of worldwide combined reporting. Some of these bills are:

38a. H.R. 11798 (Willis) (1965)
38b. S. 916 (Ribicoff) (1969)
38c. S. 317 (Ribicoff) (1971)
38d. S. 4080 (Mathias) (1972)
38e. S. 2173 (Mathias) (1977)
38f. S. 1688 (Mathias) (1979)
38g. H.R. 5076 (Conable) (1979)
38h. H.R. 5903 (Satterfield) (1979)
38i. H.R. 8277 (Broyhill) (1980)
38j. H.R. 1983 (Conable) (1981)
38k. H.R. 6402 (Rodino) (1982)
38l. H.R. 2918 (Conable) (1983)
38m. H.R. 3243 (Frenzel) (1983)
38n. S. 1225 (Mathias) (1983)
38o. H.R. 4940 (Wyden) (1984)
38p. H.R. 6146 (Mica) (1984)
38q. S. 3061 (Hawkins) (1984)
38r. H.R. 3980 (Duncan) (1985)
38s. S. 1113 (Mathias) (1985)
38t. S. 1974 (Wilson) (1985)

39. The FTB and various committees of the California State Legislature have held hearings on California's use of world-wide combined reporting, some of which have been transcribed, as follows:

39a. Hearing of State of California Franchise Tax Board, Monday, August 22, 1977, 9:30 a.m.

39b. Hearing of State of California Franchise Tax Board, Tuesday, July 12, 1977, 10:00 a.m.

39c. Hearing, Assembly Revenue and Taxation Committee, Willie L. Brown, Jr., Chairman, Los Angeles, November 1979.

39d. Interim Hearing, Assembly Committee on Revenue and Taxation, San Diego, November 7, 1980.

40. As of January 30, 1986, the United States was a party to income tax treaties for the avoidance of double taxation with thirty-three (33) countries, as follows:

40a. Convention between the Government of the United States of America and the Government of Australia for the Avoidance of Double Taxation, signed August 6, 1982, entered into force October 31, 1983.

40b. Convention between the Government of the United States of America and the Government of Austria for the Avoidance of Double Taxation, signed October 25, 1956, entered into force October 10, 1957.

40c. Convention between the Government of the United States of America and the Government of Belgium for the Avoidance of Double Taxation, signed July 9, 1970, entered into force October 13, 1972.

40d. Convention between the Government of the United States of America and the Government of Canada for the Avoidance of Double Taxation, signed September 26, 1980, amended by protocols signed June 14, 1983 and March 23, 1984, entered into force August 16, 1984.

40e. Convention between the Government of the United States of America and the Government of Denmark for the Avoidance of Double Taxation, signed May 6, 1948, entered into force December 1, 1948.

40f. Convention between the Government of the United States of America and the Government of Egypt for the Avoidance of Double Taxation, signed August 24, 1980, entered into force December 31, 1981.

40g. Convention between the Government of the United States of America and the Government of Finland for the Avoidance of Double Taxation, signed March 6, 1970, entered into force February 28, 1971.

40h. Convention between the Government of the United States of America and the Government of France for the Avoidance of Double Taxation, signed June 28, 1967, entered into force August 11, 1968, modified by protocol signed October 12, 1970, entered into force February 21, 1971, modified by protocol dated November 24, 1978, entered into force October 27, 1979.

40i. Convention between the Government of the United States of America and the Government of the Federal Republic of Germany for the Avoidance of Double Taxation, signed July 22, 1954, entered into force December 20, 1954, modified by protocol signed September 17, 1965, entered into force December 27, 1965.

40j. Convention between the Government of the United States of America and the Government of Greece for the Avoidance of Double Taxation, signed April 20, 1953, amended by protocol dated April 20, 1953, entered into force December 30, 1953.

40k. Convention between the Government of the United States of America and the Government of Hungary for the Avoidance of Double Taxation, signed February 12, 1979, entered into force September 18, 1979.

40l. Convention between the Government of the United States of America and the Government of Iceland for the Avoidance of Double Taxation, signed May 7, 1975, entered into force December 26, 1975.

40m. Convention between the Government of the United States of America and the Government of Ireland for the Avoidance of Double Taxation, signed September 13, 1949, entered into force December 20, 1951.

40n. Convention between the Government of the United States of America and the Government of Italy for the Avoidance of Double Taxation, signed March 30, 1955, entered into force October 26, 1956.

40o. Convention between the Government of the United States of America and the Government of Jamaica for the Avoidance of Double Taxation, signed May 21, 1980, amended by protocol signed May 21, 1980, entered into force December 29, 1981.

40p. Convention between the Government of the United States of America and the Government of Japan for the Avoidance of Double Taxation, signed March 8, 1971 entered into force July 9, 1972.

40q. Convention between the Government of the United States of America and the Government of Korea for the Avoidance of Double Taxation, signed June 4, 1976, entered into force October 29, 1979.

40r. Convention between the Government of the United States of America and the Government of Luxembourg for the Avoidance of Double Taxation, signed December 18, 1962, entered into force December 22, 1984.

40s. Convention between the Government of the United States of America and the Government of Malta for the avoidance of Double Taxation, signed March 21, 1980, entered into force May 18, 1982.

40t. Convention between the Government of the United States of America and the Government of Morocco for the Avoidance of Double Taxation, signed August 1, 1977, entered into force December 30, 1981.

40u. Convention between the Government of the United States of America and the Government of the Kingdom of the Netherlands for the Avoidance of Double Taxation, signed April 29, 1948, entered into force December 1, 1948, as modified by supplementary convention signed December 30, 1965, entered into force July 8, 1966.

40v. Convention between the Government of the United States of America and the Government of New Zealand for the Avoidance of Double Taxation, signed July 23, 1982, entered into force November 2, 1983.

40w. Convention between the Government of the United States of America and the Government of Norway for the Avoidance of Double Taxation, signed December 3, 1971, entered into force November 29, 1972, modified by protocol signed September 19, 1980, entered into force December 15, 1981.

40x. Convention between the Government of the United States of America and the Government of Pakistan for the Avoidance of Double Taxation, signed July 1, 1957, entered into force May 21, 1959.

40y. Convention between the Government of the United States of America and the Government of the Philippines for the Avoidance of Double Taxation, signed October 1, 1976, entered into force October 16, 1982.

40z. Convention between the Government of the United States of America and the Government of Poland for the Avoidance of Double Taxation, signed October 8, 1974, entered into force June 22, 1976.

40aa. Convention between the Government of the United States of America and the Government of Romania for the Avoidance of Double Taxation, signed December 4, 1973, entered into force February 26, 1976.

40bb. Convention between the Government of the United States of America and the Government of Sweden for the Avoidance of Double Taxation, signed March 23, 1939, entered into force November 14, 1939, modified by supplementary convention signed October 22, 1963, entered into force September 11, 1964.

40cc. Convention between the Government of the United States of America and the Government of Switzerland for the Avoidance of Double Taxation, signed May 24, 1951, entered into force September 22, 1951.

40dd. Convention between the Government of the United States of America and the Government of Trinidad and Tobago for the Avoidance of Double Taxation, signed January 9, 1970, entered into force December 30, 1970.

40ee. Convention between the Government of the United States of America and the Government of the Republic of South Africa for the Avoidance of Double Taxation, signed December 13, 1946, entered into force July 15, 1952, modified by supplementary protocol signed July 14, 1950, entered into force July 15, 1952.

40ff. Convention between the Government of the United States of America and the Government of the Union of Soviet Socialist Republics for the Avoidance of Double Taxation, signed June 20, 1973, entered into force January 29, 1976.

40gg. Convention between the Government of the United States of America and the Government of the Kingdom of Great Britain and Northern Ireland for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and Capital Gains, signed December 31, 1975, entered into force April 25, 1980, modified by notes exchanged on April 13, 1976, amended by first protocol signed August 26, 1976, second protocol signed March 31, 1977, and third protocol signed March 15, 1979, all entered into force July 25, 1980.

41. As of December 16, 1985, the United Kingdom was a party to seventy-eight (78) treaties for the avoidance of double taxation on income, as follows:

41a. Double Taxation Relief (Antigua) Order 1947 (S.R. & O 1947 No. 2865), amended (S.I. 1968 No. 1096).

41b. Double Taxation Relief (Australia) Order 1967 (S.I. 1968 No. 305), protocol (S.I. 1980 No. 707).

41c. Double Taxation Relief (Austria) Order 1970 (S.I. 1947 No. 1947), protocol 1980 (S.I. 1979 No. 117).

41d. Double Taxation Relief (Bangladesh) Order 1979 (S.I. 1980 No. 1947), protocol 1980 (S.I. 1979 No. 708).

41e. Double Taxation Relief (Barbados) Order 1970 (S.I. 1970 No. 952), protocol 1973 (S.I. 1973 No. 2096).

41f. Double Taxation Relief (Belgium) Order 1967 (S.I. 1970 No. 636).

41g. Double Taxation Relief (Belize) Order 1947 (S.R. & O 1947 No. 2866), amended 1962 (S.I. 1968 No. 573), amended 1973 (S.I. 1973 No. 2097).

41h. Double Taxation Relief (Botswana) Order 1977 (S.I. 1978 No. 183).

41i. Double Taxation Relief (Brunei) Order 1950 (S.I. 1950 No. 1977), amended 1968 (S.I. 1968 No. 306), amended 1973 (S.I. 1973 No. 2098).

41j. Double Taxation Relief (Burma) Order 1950, protocol 1951 (S.I. 1952 No. 751).

41k. Double Taxation Relief (Canada) Order 1978 (S.I. 1980 No. 709), protocol 1980 (S.I. 1980 No. 1528), protocol (S.I. 1985 No. 1996).

41l. Double Taxation Relief (China) Order 1984 (S.I. 1984 No. 1826).

41m. Double Taxation Relief (Cyprus) Order 1974 (S.I. 1975 No. 425), protocol 1980 (S.I. 1980 No. 1529).

41n. Double Taxation Relief (Denmark) Order 1980 (S.I. 1980 No. 1960).

41o. Double Taxation Relief (Dominican Republic) Order 1949 (S.I. 1949 No. 359), amended 1968 (S.I. 1968 No. 1098).

41p. Double Taxation Relief (Egypt) Order 1980 (S.I. 1980 No. 1091).

41q. Double Taxation Relief (Falkland Islands) Order 1984 (S.I. 1984 No. 363).

41r. Double Taxation Relief (Faroe Islands) Order 1950 (S.I. 1950 No. 1195), extended 1960 (S.I. 1961 No. 579), protocol 1969 (S.I. 1969 No. 1068), extended 1970 (S.I. 1971 No. 717), protocol 1973 (S.I. 1973 No. 1326), extended 1975 (S.I. 1975 No. 2190).

41s. Double Taxation Relief (Fiji) Order 1975 (S.I. 1976 No. 1342).

41t. Double Taxation Relief (Finland) Order 1969 (S.I. 1970 No. 153), protocol 1979 (S.I. 1980 No. 710), protocol 1984 (S.I. 1985 No. 1997).

41u. Double Taxation Relief (France) Order 1968 (S.I. 1968 No. 1869), protocol 1973 (S.I. 1973 No. 1328).

41v. Double Taxation Relief (Gambia) Order 1980 (S.I. 1980 No. 1963).

41w. Double Taxation Relief (Federal Republic of Germany) Order 1964 (S.I. 1967 No. 25), protocol 1970 (S.I. 1971 No. 874).

41x. Double Taxation Relief (Ghana) Order 1977 (S.I. 1978 No. 785).

41y. Double Taxation Relief (Greece) Order 1953 (S.I. 1954 No. 142).

41z. Double Taxation Relief (Grenada) Order 1949 (S.I. 1949 No. 361), amended 1968 (S.I. 1968 No. 1867).

41aa. Double Taxation Relief (Guernsey) Order 1952 (S.I. 1952 No. 1215).

41bb. Double Taxation Relief (Hungary) Order 1977 (S.I. 1978 No. 1056).

41cc. Double Taxation Relief (India) Order 1981 (S.I. 1981 No. 1120).

41dd. Double Taxation Relief (Indonesia) Order 1975 (S.I. 1975 No. 2191).

41ee. Double Taxation Relief (Republic of Ireland) Order 1976 (S.I. 1976 No. 2151), protocol 1976 (S.I. 1976 No. 2152).

41ff. Double Taxation Relief (Isle of Man) Order 1955 (S.I. 1955 No. 1205).

41gg. Double Taxation Relief (Israel) Order 1962 (S.I. 1962 No. 616), protocol 1970 (S.I. 1971 No. 391).

41hh. Double Taxation Relief (Italy) Order 1960, exchange of notes 1960 (S.I. 1962 No. 2787), protocol 1969 (S.I. 1973 No. 1763).

41ii. Double Taxation Relief (Jamaica) Order 1973 (S.I. 1973 No. 1329).

41jj. Double Taxation Relief (Japan) Order 1969, exchange of notes 1969 (S.I. 1970 No. 1948), protocol 1980 (S.I. 1980 No. 1530).

41kk. Double Taxation Relief (Jersey) Order 1952 (S.I. 1952 No. 1216).

41ll. Double Taxation Relief (Kenya) Order 1973, protocol 1976, exchange of notes 1977 (S.I. 1977 No. 1299).

41mm. Double Taxation Relief (Kiribati and Tuvalu) Order 1950 (S.I. 1950 No. 750), amended 1968 (S.I. No. 309), amended 1974 (S.I. 1974 No. 1271).

41nn. Double Taxation Relief (Korea) Order 1977, protocol 1977 (S.I. 1978 No. 786).

41oo. Double Taxation Relief (Lesotho) Order 1949 (S.I. No. 2197), amended 1968 (S.I. 1968 No. 1868).

41pp. Double Taxation Relief (Luxembourg) Order 1967 (S.I. 1968 No. 1100), protocol 1978 (S.I. 1980 No. 567), protocol 1983 (S.I. 1984 No. 364).

41qq. Double Taxation Relief (Malawi) Order 1955 (S.I. 1956 No. 619), amended 1964 (S.I. 1964 No. 1401), amended 1968 (S.I. 1968 No. 1101), amended 1978 (S.I. 1978 No. 302).

41rr. Double Taxation Relief (Malaysia) Order 1973, protocol 1973 (S.I. 1973 No. 1330).

41ss. Double Taxation Relief (Malta) Order 1962 (S.I. 1962 No. 639), amended 1974 (S.I. 1975 No. 426).

41tt. Double Taxation Relief (Mauritius) Order 1981 (S.I. 1981 No. 1121).

41uu. Double Taxation Relief (Montserrat) Order 1947 (S.I. 1947 No. 2868), amended 1968 (S.I. 1968 No. 576).

41vv. Double Taxation Relief (Namibia) Order 1962 (S.I. 1962 No. 2352), extended 1962 (S.I. 1962 No. 2788), protocol 1967 (S.I. 1967 No. 1489), extended 1967 (S.I. 1967 No. 1460).

41ww. Double Taxation Relief (Netherlands) Order 1980 (S.I. 1980 No. 1961), protocol 1983 (S.I. 1983 No. 1902).

41xx. Double Taxation Relief (Netherlands Antilles) Order 1967 (S.I. 1968 No. 577), extended 1970 (S.I. 1970 No. 1949).

41yy. Double Taxation Relief (New Zealand) Order 1983, exchange of notes 1983 (S.I. 1984 No. 365).

41zz. Double Taxation Relief (Norway) Order 1985 (S.I. 1985 No. 1998).

41aaa. Double Taxation Relief (Pakistan) Order 1961 (S.I. 1961 No. 2467).

41bbb. Double Taxation Relief (Philippines) Order 1976 (S.I. 1978 No. 184).

41ccc. Double Taxation Relief (Poland) Order 1976 (S.I. 1978 No. 282).

41ddd. Double Taxation Relief (Portugal) Order 1968 (S.I. 1969 No. 599).

41eee. Double Taxation Relief (Romania) Order 1975, exchange of notes 1976 (S.I. 1977 No. 57).

41fff. Double Taxation Relief (St. Christopher & Nevis (St. Kitts)) Order 1947 (S.I. 1947 No. 2872).

41ggg. Double Taxation Relief (St. Lucia) Order 1949 (S.I. 1949 No. 366), amended 1968 (S.I. 1968 No. 1102).

41hhh. Double Taxation Relief (St. Vincent & Grenadines) Order 1949 (S.I. 1949 No. 367), amended 1968 (S.I. 1968 No. 1103).

41iii. Double Taxation Relief (Sierra Leone) Order 1947 (S.I. 1947 No. 2873), amended 1968 (S.I. 1968 No. 1104).

41jjj. Double Taxation Relief (Singapore) Order 1966 (S.I. 1967 No. 483), protocol 1975, exchange of notes 1975, 1976, 1977 (S.I. 1978 No. 787).

41kkk. Double Taxation Relief (Solomon Islands) Order 1950 (S.I. 1950 No. 748), amended 1968 (S.I. 1968 No. 574), amended 1974 (S.I. 1974 No. 1270).

41lll. Double Taxation Relief (South Africa) Order 1968 (S.I. 1969 No. 864).

41mmm. Double Taxation Relief (Spain) 1975 (S.I. 1976 No. 1919).

41nnn. Double Taxation Relief (Sri Lanka) Order 1979, exchange of notes 1980 (S.I. 1980 No. 713).

41ooo. Double Taxation Relief (Sudan) Order 1975 (S.I. 1979 No. 1719).

41ppp. Double Taxation Relief (Swaziland) Order 1968 (S.I. 1968 No. 380).

41qqq. Double Taxation Relief (Sweden) Order 1983 (S.I. 1984 No. 366), protocol 1984 (S.I. 1984 No. 366).

41rrr. Double Taxation Relief (Switzerland) Order 1977 (S.I. 1978 No. 1408), protocol 1981 (S.I. 1982 No. 714).

41sss. Double Taxation Relief (Thailand) Order 1981 (S.I. 1981 No. 1546).

41ttt. Double Taxation Relief (Trinidad & Tobago) Order 1982 (S.I. 1983 No. 1903).

41uuu. Double Taxation Relief (Tunisia) Order 1982 (S.I. 1984 No. 1336).

41vvv. Double Taxation Relief (Uganda) Order 1952 (S.I. 1952 No. 1213).

41www. Double Taxation Relief (United States of America) Order 1975, exchange of notes 1976, protocol 1976, protocol 1977, protocol 1979 (S.I. 1980 No. 568).

41xxx. Double Taxation Relief (Yugoslavia) Order 1981 (S.I. 1981 No. 1815).

41yyy. Double Taxation Relief (Zambia) Order 1972 (S.I. 1972 No. 1721), protocol 1981 (S.I. 1981 No. 1816).

41zzz. Double Taxation Relief (Zimbabwe) Order 1982 (S.I. 1982 No. 1842).

42. By an exchange of notes dated September 26, 1980, between the Honorable Allan J. MacEachen, Deputy Prime Minister and Minister of Finance of Canada and G. William Miller, Secretary of Treasury of the United States, in conjunction with the execution of the Convention For Avoidance of Double Taxation between the United States and Canada, the Government of Canada set forth its position on the issue of the so-called "unitary apportionment" method used by certain states of the United States and the United States agreed to reopen discussions

with Canada on this subject if an acceptable provision on this subject can be devised.

43. By an exchange of notes dated November 24, 1978, between George S. Vest, Assistant Secretary of State for European Affairs, and Francois de Laboulaye, Ambassador of France, in conjunction with the execution of the protocol dated November 24, 1978, to the Convention for the Avoidance of Double Taxation between the United States and France, the Government of France set forth its position on the so-called "unitary apportionment" method used by certain states of the United States, and the Government of the United States and the Government of the United States agreed to reopen discussions with France on this subject if an acceptable provision on this subject can be devised.

44. In 1963, the Committee on Fiscal Affairs to the Council of the Organization for Economic Co-operation and Development ("OECD") published the Draft Double Taxation Convention on Income and Capital. In 1977, the OECD revised and published its new Model Double Taxation Convention on Income and on Capital. The conventions are both contained in the 1977 Report of the OECD Committee on Fiscal Affairs, "Model Double Taxation Convention on Income and on Capital."

45. In 1977, the Government of the United States of America published its Model Convention For the Avoidance of Double Taxation on Income and Capital. This document was revised in 1981 and is entitled "United States Draft Model Income Tax Treaty."

46. Correspondence, statements or press releases from various government officials throughout the United States have been issued, some of which are as follows:

46a. Letter from Secretary of Treasury, James A. Baker III to the President of the United States Senate regarding the introduction of Unitary Tax Repealer Act, dated December 18, 1985.

46b. Letter from the Honorable Barber B. Conable, Jr. to the Honorable John E. Chapoton with enclosed statement of the Honorable Conable to be submitted to the Unitary Taxation Group's Task Force, dated November 23, 1983.

46c. Letter to the Honorable Barber B. Conable, Jr. from the Honorable Donald C. Lubick, Assistant Secretary of the Treasury regarding unitary taxation, dated April 22, 1980.

46d. Statement by the Honorable Allen Wallis, Under Secretary of State for Economic Affairs concerning the Chairman's Working Group Report, as taken from the Final Report of the Worldwide Unitary Taxation Group, August 1984.

46e. Statement by the Honorable Donald C. Lubick, Assistant Secretary of the Treasury for Tax Policy, before the Senate Finance Subcommittee on Taxation and Debt Management Generally on S. 983 and S. 1688, dated June 24, 1980.

46f. Statement by the Honorable Donald C. Lubick, Assistant Secretary of the Treasury for Tax Policy, before the House Ways and Means Committee on H.R. 5076, dated March 31, 1980.

46g. Press release #255 from the Office of the Governor of California regarding California's unitary tax, dated May 1, 1984.

46h. Letter from the Honorable George P. Schultz to the Honorable George Deukmejian regarding unitary taxation, dated January 30, 1986.

46i. Reply from Honorable George Deukmejian to the letter of January 30, 1986, from the Honorable George P. Schultz.

47. The Organization for Economic Co-operation and Development (OECD) issued a report on transfer pricing entitled "Transfer Pricing and Multinational Enterprises" (Paris OECD, 1979).

48. The Organization for Economic Co-operation and Development (OECD) issued a report on transfer pricing entitled "Transfer Pricing and Multinational Enterprises, Three Taxation Issues" (Paris OECD, 1984).

49. The administration of Internal Revenue Code Section 482 by the Internal Revenue Service, and its effectiveness generally, has been studied and reported on by certain governmental agencies of the United States, as follows:

49a. Comptroller General of the United States, No. GGD-51-81, Report to the Chairman, House Committee on Ways and Means, IRS Could Better Protect U.S. Tax Interests in Determining the Income of Multinational Corporations (September 30, 1981).

49b. Report to the Associate Commissioner of the Internal Revenue Service, Internal Revenue Service of Study of International Cases Involving Section 482 of the Internal Revenue Code (1982).

50. State taxation of multinational corporations has been the subject of reports, some of which are:

50a. "Key Issues Affecting State Taxation of Multi-jurisdictional Corporate Income Need Resolving", a report to the Chairman of the House Committee on Ways and Means from the Comptroller General of the United States and published on July 1, 1982 in the General Accounting Office.

50b. Report of the Advisory Commission on Intergovernmental Relations, "State Taxation of Multi-national Corporations" dated November 1982.

50c. Report of Advisory On Intergovernmental Relations, "State Taxation of Multinational and Multistate Corporations" dated September 4, 1981.

51. Internal records of members of the Barclays Group were produced by plaintiffs to defendants in discovery, some of which are as follows:

51a. Letter from A. H. Dalton to I. M. Cobbold, Esq., dated August 3, 1979. (000176-000177)

51b. Letter dated P. J. Chapman to G. J. Lyall, Esq., dated April 13, 1983. (000594-000595)

51c. Letter from Price Waterhouse to Secretary, Inland Revenue, dated April 1, 1982. (000631-000633)

51d. Letter from J. A. Dally to Price Waterhouse, dated May 13, 1982. (000630)

51e. BBL Reports and Accounts – 1977. (000256-000308)

51f. BBI Reports and Accounts – 1977. (000221-000255)

51g. Preliminary Prospectus dated March 31, 1981 $125,000,000 Barclays North American Capital Corporation % Guaranteed Capital Notes due 2006. (000424-000521)

51h. Barclays International-World of Banking — List of Offices Nov. 1977. (000309-000423)

51i. Barclays Bank International Limited claim for double tax relief — September 30, 1977. (000639-000646)

51j. Reconciliation between agreed local taxable profit and UK adjusted profit for purposes of double tax relief September 30, 1977. (000801-000828)

51k. A-T Schedule for Barclays Bank of California for the income year 1977. (002064-002092)

51l. Annual Return/Report of Employee Benefit Plan — U.S. Form 5500 and supporting documents. (003131-003160)

51m. Barclays Bank of California U.S. Corporation Income Tax Return for Income Year 1977 — U.S. Form 1120 and supporting documents. (003261-003209)

51n. BBI U.S. Corporate Income Tax for Income Year 1977 — Form 1120F. (003217-003225)

51o. Barclays Bank of California — California tax return for income year ending September 30, 1977. (003226-003250)

51p. BBI California tax return for income year ending September 30, 1977. (003251-003261)

51q. Barclays Group Management Accounts — December 31, 1977. (003610-003614)

51r. Barclays Group-Supporting schedules to financial accounts December 31, 1977. (003615-003629)

51s. The Barclays Group-Divisional Operating Profit; Reconciliation of Financial and Management Results. (003630-003687)

51t. Interest in subsidiaries and associated companies, December 31, 1977.

51u. Consolidation Schedules. (003708-003752)

51v. Letter D. Elvidge, Head Group Taxation Barclays Plc to J.H. Hall, Inland Revenue dated April 14, 1986.

51w. Letter J.H. Hall, Inland Revenue to David Elvidge, Head Group Taxation Barclays Plc, dated April 16, 1986.

This stipulation is made this 9th day of September, 1986.

JOANNE M. GARVEY
LAWRENCE W. JORDAN, JR.
JOAN K. IRION
JORDAN, KEELER & SELIGMAN

By ____________________
Joanne M. Garvey
Counsel for Plaintiffs

JOHN VAN DE KAMP, Attorney General of the State of California
EDWARD P. HOLLINGSHEAD, Supervising Deputy Attorney General

By ____________________
Robert Milam
Deputy Attorney General
Counsel for Defendant

CERTIFICATE OF SERVICE BY MAIL

I, Rhoda L. Fone, declare that I am a citizen of the United States, over the age of 18, and not a party to or interested in the within entitled cause; that I am an employee of JORDAN, KEELER & SELIGMAN, and that my business address is 1400 Alcoa Building, One Maritime Plaza, San Francisco, California 94111; that on November 3, 1986, I served the within JOINT STIPULATION OF FACTS by placing a true copy thereof in a sealed envelope with postage fully prepaid, in the United States Post Office mail box, in the City and County of San Francisco, California addressed as follows:

Robert D. Milam, Esq.
Deputy Attorney General
1515 K Street
Sacramento, California 94244-2550

I declare under penalty of perjury that the foregoing is true and correct.

Executed on November 3, 1986, at San Francisco, California.

____
Rhoda L. Fone

JOHN K. VAN DE KAMP, Attorney
General of the State of California
TIMOTHY G. LADDISH
Supervising Deputy Attorney General
RICHARD E. NEILSEN
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Attorneys For Defendant

SUPERIOR COURT OF CALIFORNIA
COUNTY OF SACRAMENTO

BARCLAYS BANK INTERNATIONAL LTD.,
a corporation of the
Country of England,
Plaintiff,

vs.

FRANCHISE TAX BOARD, an agency
of the State of California,
Defendant.

BARCLAYS BANK OF CALIFORNIA,
a California Corporation,
Plaintiff,

vs.

FRANCHISE TAX BOARD, an agency
of the State of California,
Defendant.

No. 325059 — No. 325061
(Consolidated for Purposes of Trial)

FILED: November 10, 1986
Joyce Russell Smith, Clerk

By S. GODFREY
Deputy

SCHEDULE II

SECOND STIPULATION OF FACTS AND DOCUMENTS

IT IS HEREBY STIPULATED by and between the parties, through their attorneys of record, that the following further facts and documents are agreed to and undisputed. This stipulation shall not be construed as a concession by either party of the relevancy or materiality of any of the facts stipulated, and the parties reserve the right to argue the relevance, materiality or weight of any of the facts stipulated.

All further documents referred to herein or specifically enumerated are compiled under separate cover, have been reviewed by counsel for the parties and their authenticity and foundational basis admitted. The documents shall be entered into evidence. Nothing contained in this stipulation shall prevent a party from introducing at trial any other or further evidence. With permission of Court, documents described in paragraphs 32, 40, and 41 hereof will be deemed admitted in evidence in entirety without physically presenting the same at trial. Either party may refer to said documents in summary form or as individual exhibits at trial or on appeal as evidence admitted at trial.

Nothing contained herein shall be construed as a waiver by any party of its right to review on appeal any question of law or fact arising in this action in the same manner and to the same extent as if the facts set forth herein had been proven in open court.

This stipulation shall only apply to the above-entitled consolidated actions and to any appeals from the judgment of this Court.

FACTS AND DOCUMENTS

The following facts are agreed to and undisputed and the following documents shall be entered into evidence:

28. Continued

28a. Announcement of the Establishment of the Working Group. 48 Fed. Reg. No. 208, page 49570, October 26, 1983.

32. Continued

32ff. Demarche from Greece, as President of the EEC, on behalf of the Ten European Economic Community Governments to the Department of State, Washington D.C. dated September 23, 1983 with attached Note.

32gg. Aide-memoire from the Government of Japan to the United States Government, dated August 11, 1983.

32hh. Demarche from the Embassy of Ireland as President of the EEC, on behalf of the governments of member states and the Commission of the European Communities to the Department of State, dated December 20, 1984.

32ii. Note Verbale of the Delegation of the Commission of the European Communities and the Embassy of Luxembourg on behalf of the EEC, to the Department of State, dated August 8, 1985.

32jj. Demarche from the Ambassador of Luxembourg and the Head of the Delegation of the Commission of the European Communities to the Department of State, dated August 30, 1985 with attached letter to Treasury Secretary Baker dated August 30, 1985 and attached Note Verbal.

32kk. Note on Worldwide Unitary Taxation from J. Raoul Schoumaker, Ambassador of Belgium, on behalf of the Member States of the European Commission and the Ambassador of Australia, Canada, Japan and Switzerland to Under Secretary of State Allen Wallis and Treasury Secretary Donald Regan, dated January 27, 1984 with cover letter, dated January 30, 1984, enclosing the same to Sir Roy Denman, Head of the Delegation of the Commission of the European Communities.

32ll. Motion for Resolution of the EEC dated October 27, 1983.

37. Continued

37h. Hearing before the Committee on Foreign Relations of the United States Senate on Six International Tax Treaties and Protocols, 96th Congress, 1st Sess. (June 6, 1979).

37i. Hearing before the Subcommittee on Taxation and Debt Management of the Congress on Finance on S.1113 and S.1974, 99th Congress, 2d Sess. (September 29, 1986).

46. Continued

46j. Letter from Michael Blumenthal, Secretary of Treasury to Martin Huff, Executive Officer California Franchise Tax Board, February 15, 1977.

46k. Letter from John S. Chapoton, Assistant Secretary Treasury (Tax Policy) to William J. Anderson, Director, General Government Division U.S., GAO Washington D.C., dated July 10, 1981.

46l. Letter from Donald Regan, Secretary of Treasury, to William Brock, United States Trade Representative, dated February 12, 1982.

46m. Letter from William Brock, United States Trade Representative to Donald Regan, Secretary of Treasury, dated February 22, 1982.

46n. Letter from Treasury Secretary James A. Baker III to House Ways and Means Committee Chairman, Dan Rostenkowski, dated March 5, 1986.

46o. Letter from Treasury Secretary James A. Baker III to Senate Finance Committee Chairman Bob Packwood, dated March 17, 1986.

46p. Letter from Treasury Secretary James A. Baker III to Speaker of the House of Representatives, Hon. Thomas P. O'Neill, Jr., dated December 18, 1985.

51. Continued

51x. BBI 1977 New York State Tax Return (Doc. No. 32678-3271).

53. The United Nations Model Double Taxation Convention Between Developed and Developing Countries, 1980.

54. United Kingdom Government Statement in Response to the Statement of the President dated November 8, 1985.

55. California Senate Bill 85 (Alquist) signed by Governor Deukmejian September 5, 1986, an act to add Chapter 1.9 (commencing with Section 15365), Chapter 6 (commencing with Section 15397) and Chapter 7 (commencing with Section 15398) to Part 6.7 of Division 3 of, and to add Article 12 (commencing with Section 16429.30) to Chapter 2 of Part 2 of Division 4 of, Title 2 of, the Government Code, to amend Sections 24274, 24344, 24348, 24667, and 24668 of, to amend and renumber Section 25110 of, to add Sections 24411 and 24670 to, and to add and repeal Article 1.5 (commencing with Section 25110) of Chapter 17 of Part 11 of Division 2 of, the Revenue and Taxation Code, relating to taxation.

56. United Kingdom Government Statement in Response to passage of Senate Bill 85, dated 5 September 1986.

57. Memo to File from Benjamin F. Miller regarding UDITPA Regulations 25137(m) and 25137(o) dated September 23, 1981 with attached Proposed Guidelines for the Preparation of Combined Reports which Include Foreign Country Operations.

58. Summary of Comments, Responses and Recommendations on Proposed Regulation 25137(m) Combined Reports Including Foreign Country Operation.

59. Summary of Comments Received Regarding FTB 1046 (12-79) and Department Responses.

60. US/USSR Treaty hearings and documents including letter from George Shultz to Nikolai Patolicher, Report of the Department of State, and the Report of the Senate Foreign Relations Committee.

This stipulation is made this 10th day of November, 1986.

JOANNE M. GARVEY LAWRENCE W. JORDAN, JR. JOAN K. IRION JORDAN, KEELER & SELIGMAN	JOHN VAN DE KAMP, Attorney General of the State of California EDWARD P. HOLLINGSHEAD, Supervising Deputy Attorney General
By ____________________ Joanne M. Garvey Counsel for Plaintiffs	By ____________________ Robert Milam Deputy Attorney General Counsel for Defendant

JOANNE M. GARVEY
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Attorneys for Defendant

SUPERIOR COURT OF THE STATE OF CALIFORNIA
COUNTY OF SACRAMENTO

BARCLAYS BANK OF CALIFORNIA,
a California Corporation,
Plaintiff,

v.

FRANCHISE TAX BOARD, an agency
of the State of California,
Defendant.

BARCLAYS BANK INTERNATIONAL, LIMITED,
a corporation of the Country of England,
Plaintiff,

v.

FRANCHISE TAX BOARD, an agency
of the State of California,
Defendant.

No. 325061
No. 325059

ENDORSED
Filed: December 20, 1985
Joyce Russell Smith, Clerk
By J.L. Holloway, Deputy

STIPULATION AND ORDER REGARDING CLOSE OF DISCOVERY

IT IS HEREBY STIPULATED AND AGREED By Plaintiffs, Barclays Bank of California and Barclays Bank International Limited, and Defendant, The Franchise Tax Board, the parties hereto, by and through their respective counsel of record, that discovery for all matters shall close at the conclusion of business on February 14, 1986, which is ten days prior to trial.

DATED: December 10, 1985

JOHN K. VAN DE KAMP
Attorney General

EDWARD P. HOLLINGSHEAD
Supervising Deputy Attorney

By: ______________________
ROBERT D. MILAM
Deputy Attorney General

Attorneys for Defendant
Franchise Tax Board

DATED: December 10, 1985

JORDAN, KEELER & SELIGMAN

By: ______________________
JOAN K. IRION

Attorneys for Plaintiffs
Barclays Bank of California and
Barclays Bank International
Limited

ORDER

IT IS SO ORDERED.

DATED: December 20, 1985

FRED W. MARLER JR. (CCP635)
Acting Presiding Judge
JUDGE OF THE SUPERIOR
COURT

APPENDIX B

CERTIFIED FOR PUBLICATION

IN THE COURT OF APPEAL OF
THE STATE OF CALIFORNIA IN AND FOR
THE THIRD APPELLATE DISTRICT
(Sacramento)

BARCLAYS BANK INTERNATIONAL, LTD.,
Plaintiff and Respondent,
v.
FRANCHISE TAX BOARD,
Defendant and Appellant.

BARCLAYS BANK OF CALIFORNIA,
Plaintiff and Respondent,
v.
FRANCHISE TAX BOARD,
Defendant and Appellant.

C003388
(Super. Ct. Nos. 325059 & 325061)

Filed November 30, 1990

COURT OF APPEAL - THIRD DISTRICT

BY Robert L. Liston, Clerk
DEPUTY

APPEAL from judgments of the Superior Court of Sacramento County, George E. Paras, Retired Associate Justice of the Court of Appeal, sitting under assignment by the Chairperson of the Judicial Council. Affirmed.

John K. Van de Kamp, Attorney General, Timothy G. Laddish, Assistant Attorney General, Robert F. Tyler, Supervising

Deputy Attorney General, and Robert D. Milam, Deputy Attorney General, for Defendant and Appellant.

Joanne M. Garvey, Joan K. Irion, Teresa A. Maloney, and Heller, Ehrman, White & McAuliffe, for Plaintiffs and Respondents.

Lawrence V. Brookes and Valentine Brookes as Amici Curiae for Thorn-EMI PLC and EMI Limited, on behalf of Plaintiffs and Respondents.

Jane H. Barrett, Lawler, Felix & Hall, and F. Eugene Wirwahn as Amici Curiae for the Government of the United Kingdom and the Government of Canada, on behalf of Plaintiffs and Respondents.

David F. Levi, United States Attorney, William S. Rose, Jr., Assistant Attorney General, and Gary R. Allen, David English Carmack, John J. McCarthy, and Richard A. Correa, Attorneys, Department of Justice, as Amicus Curiae for the United States of America, on behalf of Plaintiffs and Respondents.

In this appeal we hold that California's unitary tax method of worldwide combined reporting (based on Rev. & Tax. Code, §§ 25101, 25120-25138), as applied to foreign-based unitary groups, is unconstitutional under the foreign commerce clause of the United States Constitution. (U.S. Const., art. I, § 8, cl. 3.)[1]

BACKGROUND

When a corporation conducts business in more than one jurisdiction, either through branches or subsidiaries, the proper allocation of income for tax purposes becomes an issue. Essentially, two methods of allocating income have evolved to resolve this issue: the arm's length/separate accounting method (AL/SA) and the unitary business/formula apportionment method. As to multinational corporations, California employs a common variant of the unitary method called worldwide combined reporting (WWCR).

Under the separate accounting method, the various affiliated corporations of a multijurisdictional enterprise are viewed as separate from one another and the income attributable to any particular jurisdiction is determined on the basis of internal accounting records reflecting the activity of the affiliate within that jurisdiction. To preclude tax-manipulative intercorporate transfers of goods, services or other value, this accounting method requires that the tax reporting entity deal at "arm's length" with its affiliated businesses as if they were simply unrelated entities dealing in the marketplace.

In contrast, under the unitary business/formula apportionment method of accounting employed by California (WWCR), the affiliated corporations of a multijurisdictional enterprise are treated as units of a single business — that is, as a "unitary group." (Cal. Code Regs., tit. 18, § 25137-6.) If a corporation doing business in California is deemed to be part of a unitary group, the total income for that group, including corporations or affiliates operating wholly outside California or the United States for that matter, is apportioned to California by a three-factor formula. The formula takes into account property, payroll, and sales (revenue in this case) for the group in California, as a fraction of total worldwide property, payroll, and sales. (See Rev. & Tax. Code, §§ 25128-25136; Notes, *State Worldwide Unitary Taxation: The Foreign Parent Case* (1985) 23 Columbia Journal of Transnational Law 445, fn. 2; hereafter 23 Columbia Journal.) The fraction is then multiplied against the unitary group's total

[1]During the tax year at issue (1977), section 25101 of the Revenue and Taxation Code provided in pertinent part as follows: "When the income of a taxpayer subject to the tax imposed under this part is derived from or attributable to sources both within and without the state the tax shall be measured by the net income derived from or attributable to sources within this state in accordance with the provisions of Article 2 (commencing with Section 25120 of this chapter); . . ."

Article 2 contains the California enactment of the Uniform Division of Income for Tax Purposes Act (UDITPA), which provides for formula apportionment of the net income from business activities both within and outside California in order to reach the net income attributable to California activities. (Rev. & Tax. Code, §§ 25120-25138.)

In 1982, section 25101 was amended in an insignificant fashion for our purposes. (Stats. 1982, ch. 466, § 104, p. 2055.)

income, producing an apportioned amount of such income taxable by California. Because intercorporate transactions are disregarded, it is unnecessary to make "arm's length" adjustments.

The income allocation method used by the United States and all of the other nations of the world, with a couple of minor and limited exceptions, is the AL/SA method, although this method varies in practice. However, the United States has essentially limited the application of its tax treaties to federal taxes. Apparently no nation in the world uses WWCR in any meaningful fashion.

The present controversy involves challenges to additional tax assessments for the year 1977 resulting from California's use of WWCR.[2] Those additional assessments were levied after the

[2]In 1986, California passed legislation, operative January 1, 1988, permitting taxpayers to make a "water's-edge election" notwithstanding section 25101 (Rev. & Tax. Code, § 25110 et seq.).

The "water's-edge" method is essentially an AL/SA method, and offers an alternative to the WWCR method for determining taxable income. (See Rev. & Tax. Code, §§ 25101, 25110.) Instead of accounting for the income and apportionment factors (property, payroll, and sales) of all the members of its worldwide unitary group, a corporate taxpayer making such an election accounts for the income and apportionment factors of the following entities affiliated with it, subject to some technical exceptions: corporations incorporated in the United States; any corporation, wherever incorporated, if the average of its apportionment factors within the United States is 20 percent or more; affiliated corporations which are eligible to be included in a federal consolidated tax return; domestic international sales corporations and foreign sales corporations engaged in sales in the United States; export trade corporations; any corporation not set forth previously but only to the extent of its income derived from or attributable to sources within the United States; and any affiliated corporation which is a controlled foreign corporation as defined in the Internal Revenue Code. Any corporation not subjected to WWCR under Revenue and Taxation Code section 25101 need not be included in this "water's-edge" accounting. (Rev. & Tax. Code, § 25110, subd. (a).)

In general, this election permits a taxpayer corporation to exclude the income and apportionment factors of foreign incorporated affiliates from

defendant California Franchise Tax Board (Board) determined that the plaintiff taxpayers, Barclays Bank of California (Barcal) and Barclays Bank International (BBI), and their ultimate corporate parent, Barclays Bank Limited (BBL), as well as the significant subsidiaries of BBI and BBL, constituted a unitary group.[3] Barcal was directed to pay an additional $152,420 and BBI an additional $1,678. Under protest Barcal and BBI (hereafter referred to collectively as either plaintiffs or Barclays) paid the additional taxes and this suit ensued.

the corporation's California tax base. In the context of state taxation of multinational corporations, an accounting restriction to the water's edge of the United States means that a state tax authority relies only on income derived from permanent establishments of the corporation in the United States, and not on income derived from wholly foreign interests, to calculate the corporation's franchise tax. Essentially, then, California's "water's-edge election" is a separate accounting method with the United States as the jurisdictional boundary.

Only "qualified taxpayers" can make a water's-edge election. To qualify, the corporate taxpayer must (1) consent to the taking of depositions from key corporate personnel and to the production of documents to ensure the Franchise Tax Board has the information necessary to make genuine arm's length adjustments and unitary business investigations, and (2) agree that dividends received by any affiliated entity from corporations significantly related to the unitary business constitute business income of the taxpayer. (Rev. & Tax. Code, § 25110, subd. (b) (2).) Additionally, to make the election the corporate taxpayer must enter into a five-year contract with the Franchise Tax Board, pay an annual fee, and subject itself to various conditions. (Rev. & Tax. Code, §§ 25111-25115.)

A foreign-based multinational corporation that does not make this election is subjected essentially to the 1977 taxation method at issue here. (See fn. 1, *ante*, pp. 2-3.) We emphasize, however, that the issue we confront is the constitutionality of California's unitary tax method of WWCR as applied to foreign-based unitary groups (Rev. & Tax. Code, § 25101 et seq.). Because California's "water's-edge election" is not involved in this case, we express no view regarding it. (Rev. & Tax. Code, § 25110 et seq.)

[3]Barcal and BBI do not challenge the determination that they are part of a unitary group.

Plaintiffs challenge the federal constitutionality of these additional tax assessments on foreign commerce clause and due process grounds. For us, the critical issue concerns the foreign commerce clause.

Foreign Commerce Clause

Before beginning our analysis, we note that plaintiffs also contend the WWCR unitary method is unconstitutional because it improperly interferes with the power of the executive branch of the federal government to conduct foreign affairs. (See United States v. Curtiss-Wright Export Corp. (1936) 299 U.S. 304 [81 L.Ed 255].) The Board argues here, as it did below, that plaintiffs' failure to raise the latter issue in their claim for refund precludes their assertion on appeal. The trial court rejected the argument, reasoning that the protest proceedings provided adequate notice of the issue and, more importantly, the Board lacked the authority to address constitutional issues. There is substantial evidence supporting the trial court's determination of adequate notice; it would have been a futile exercise to raise this constitutional issue involving sensitive matters of international relations before the Board. (See Park'N Fly of San Francisco, Inc. v. City of South San Francisco (1987) 188 Cal.App.3d 1201, 1208-1209, 1215-1216.) Moreover, as we shall explain, the dispute is irrelevant as the foreign commerce clause issue inextricably involves foreign affairs, the subject of foreign affairs inextricably involves the two political branches of our national government, and the foreign commerce clause issue was undeniably raised in a timely fashion. With these prefatory remarks in mind, we address the substance of the matter.

Article I, section 8, clause 3 of the United States Constitution gives Congress the power "To regulate commerce with foreign nations, and among the several states, . . ."

As noted by the trial court, three United States Supreme Court decisions that have construed this provision in the last decade are vital to the positions of each of the parties to this litigation. Those cases are: Japan Line, Ltd. v. County of Los Angeles (1979) 441 U.S. 434 [60 L.Ed.2d 336]; Container Corp. v. Franchise Tax

Bd. (1983) 463 U.S. 159 [77 L.Ed.2d 545]; and Wardair Canada v. Florida Dept. of Revenue (1986) 477 U.S. 1 [91 L.Ed.2d 1].

In *Japan Line*, the high court held that instrumentalities of commerce (in that case, cargo containers in seagoing ships) that are owned, based, and registered abroad and that are used exclusively in international commerce may not be subjected to an apportioned ad valorem property tax by a state. (441 U.S. at pp. 436, 444 [60 L.Ed.2d at pp. 340, 345].)

Through *Japan Line*, the so-called "dormant" foreign commerce clause test of constitutional review came into being. The judiciary engages in dormant commerce clause analysis when the Congress has not acted or purported to act; in such situations, it is the judiciary's responsibility to determine whether an action taken by a state unduly threatens the underlying purpose of the clause: to ensure a free flow of commerce and that individual states do not work to the detriment of the nation as a whole. (Merrion v. Jicarilla Apache Tribe (1982) 455 U.S. 130, 154-155 [71 L.Ed.2d 21, 40]; *Wardair, supra*, 477 U.S. at pp. 7-8 [91 L.Ed.2d at pp. 9-10].)

This dormant foreign commerce clause test was engendered through the engrafting of two additional inquiries onto the already existing four-part test for dormant *Interstate* commerce clause review. (*Japan Line, supra*, 441 U.S. at pp. 444-445, 451 [60 L.Ed.2d at pp. 345-346, 349].)

That four-part test upholds a state tax against an interstate commerce clause challenge if the tax "'[i] is applied to an activity with a substantial nexus with the taxing State, [ii] is fairly apportioned, [iii] does not discriminate against interstate commerce, and [iv] is fairly related to the services provided by the State.'" (*Japan Line, supra*, 441 U.S. at pp. 444-445, 449, 454 [60 L.Ed.2d at pp. 345, 348, 351], quoting Complete Auto Transit, Inc. v. Brady (1977) 430 U.S. 274, 279 [51 L.Ed.2d 326, 331].) The two additional inquiries prompted by the foreign context are first, whether the tax creates a "substantial risk of international multiple taxation" (441 U.S. at p. 451 [60 L.Ed.2d at p. 349]), and, second, whether the tax "may impair federal uniformity in an area where federal uniformity is essential"

(*Id.*, at p. 448 [60 L.Ed.2d at p. 347]), and prevents "the Federal Government from 'speaking with one voice when regulating commercial relations with foreign governments.' If a state tax contravenes either of these precepts, it is unconstitutional under the Commerce Clause." (*Id.*, at p. 451 [60 L.Ed.2d at p. 349], quoting Michelin Tire Corp. v. Wages (1976) 423 U.S. 276, 285 [46 L.Ed.2d 495, 503]; *Container, supra*, 463 U.S. at pp. 193-194 [77 L.Ed.2d at p. 571].)

The court in *Japan Line* assumed, without deciding, that the tax at issue passed constitutional muster under the four-part interstate test, and proceeded to ask the two new questions. (441 U.S. at p. 451 [60 L.Ed.2d at p. 349].)

The court had little difficulty in determining that California's property tax failed the first additional test: since the facts showed that Japan taxed the cargo containers at full value, California's tax created more than the risk of multiple taxation; it in fact produced such taxation. (*Japan Line, supra*, 441 U.S. at pp. 451-452 [60 L.Ed.2d at pp. 349-350].)

The court decided rather easily that California's tax prevented the nation from "speaking with one voice" in regulating foreign trade. (*Japan Line, supra*, 441 U.S. at pp. 452-453 [60 L.Ed.2d at pp. 350-351].) The court cited the Customs Convention on Containers, which both the United States and Japan had signed, and stated it reflected a national policy to remove all duties and taxes as to temporarily-imported containers in international traffic. (*Id.*, at pp. 452-453 [60 L.Ed.2d at pp. 350-351].) Since American-owned containers are not taxed in Japan, California's tax creates an asymmetry in international taxation operating to Japan's disadvantage; under such circumstances, the risk of retaliation by Japan is acute, a retaliation that of necessity would be borne by the entire nation. Finally, if other states were to follow California's example, taxation would vary port-by-port, making speaking with one voice impossible. (*Id.*, at p. 453 [60 L.Ed.2d at pp. 350-351].)

The relative ease with which these constitutional invalidations were made is grounded in the *Japan Line* court's sensitivity to intrusions by individual states into the realm of foreign affairs.

(See also Hines v. Davidowitz (1941) 312 U.S. 52, 63 [85 L.Ed. 581, 584-585]; United States v. Belmont (1937) 301 U.S. 324, 330-331 [81 L.Ed. 1134, 1139].) As to the first inquiry, the court noted that "[e]ven a slight overlapping of tax — a problem that might be deemed de minimis in a domestic context — assumes importance when sensitive matters of foreign relations and national sovereignty are concerned." (Fn. omitted; *Japan Line, supra*, 441 U.S. at p. 456 [60 L.Ed.2d at p. 352].) When confronted with the assertion that it was Japan's levy rather than California's which created the double tax, the court responded, "California's tax, however, must be evaluated in the *realistic framework of the custom of nations* . . . ." (Emphasis added, *id.*, at p. 454 [60 L.Ed.2d at p. 351].)

Regarding the second inquiry, the court stressed that the foreign commerce power of Congress is greater than its interstate commerce power, and emphasized not only the need for uniformity in dealing with other nations but "the Framers' overriding concern that 'the Federal Government must speak with one voice when regulating commercial relations with foreign governments.'" (*Japan Line, supra*, 441 U.S. at pp. 448-449 [60 L.Ed.2d at pp. 347-348].) Of course *Japan Line* involved a property tax on a foreign cargo container, not a particular method of income tax allocation applied to a foreign-based unitary group.

The case of Container Corp. v. Franchise Tax Bd. supra, 463 U.S. 159 [77 L.Ed.2d 545], to which we turn now, involved not only a particular income tax method but the one at issue here.

Container held in part that California's application of WWCR to domestic-based unitary groups was constitutional under the dormant foreign commerce clause test enunciated in *Japan Line*. (463 U.S. at pp. 185-197 [77 L.Ed.2d at pp. 566-573].) Container Corporation was a business entity incorporated in Delaware and headquartered in Illinois with 20 subsidiaries in 4 European and 4 Latin American countries. (*Id.*, at pp. 163, 171 [77 L.Ed.2d at pp. 551, 557].)

At the outset of its foreign commerce clause discussion, the court in *Container* stated that "[t]he case most relevant to our inquiry is *Japan Line*." (463 U.S. at p. 185 [77 L.Ed.2d at

p. 566].) Following *Japan Line, Container* applied the two additional foreign commerce clause considerations there set forth. (463 U.S. at pp. 185-186 [77 L.Ed.2d at pp. 566-567].)

Before applying those two additional considerations, *Container* noted the similarities and differences between the two cases. Similarities included the fact that actual double taxation had resulted, that such taxation stemmed from a serious divergence between California and foreign taxing methods, that the foreign taxing method was consistent with international practice (i.e., AL/SA), and that "our own Federal Government, to the degree it has spoken, seems to prefer the taxing method adopted by the international community to the taxing method adopted by California." (Fn. omitted, 463 U.S. at pp. 184, 187 [77 L.Ed.2d at pp. 565, 567].)

Three differences were noted. First, the tax in *Container* was on income rather than on property, and the court noted the ease with which income traverses boundaries. Second, the double taxation, although real, was not the " 'invevitabl[e]' result of the California taxing scheme." Finally, the tax in *Container* fell, not on the foreign owners of an instrumentality of foreign commerce, but on a corporation domiciled and headquartered in the United States. (463 U.S. at pp. 187-188 [77 L.Ed.2d at pp. 567-568].) After essentially analogizing a corporation and an instrumentality of commerce, *Container* carefully noted "[w]e have no need to address in this opinion the constitutionality of combined apportionment with respect to state taxation of domestic corporations with foreign parents or foreign corporations with either foreign parents or foreign subsidiaries." (*Id.*, at p. 189, including fn. 26 [77 L.Ed.2d at p. 568].) It is important to note at this juncture that those issues are the crux of the matter presented here.

In applying the first additional test set forth in *Japan Line, Container* noted *Japan Line*'s concern that even slight overlapping of tax assumes importance in the sensitive area of foreign relations, but further noted that this concern did not express an absolute prohibition on stated-induced double taxation. While such taxation deserves close scrutiny, said *Container*, that scrutiny must take into account the context in which the double taxation takes place and the alternatives reasonably available to

the taxing state. (463 U.S. at p. 189, [77 L.Ed.2d at pp. 568-569].) Taking into account the context of the tax, the distinction between an income tax and a property tax, and the fact that even implementing AL/SA would not guarantee an end to double taxation, *Container* concluded that since California's taxing method did not "inevitably" lead to double taxation, it would be perverse to constitutionally require one method of taxation over another when both could result in a double tax. (*Id.*, at pp. 189-193 [77 L.Ed.2d at pp. 568-571].)

Proceeding to *Japan Line*'s second inquiry — that is, the "one-voice" standard — *Container* stated: "In conducting this inquiry, . . . we must keep in mind that if a state tax merely has foreign resonances, but does not implicate foreign affairs, we cannot infer, '[a]bsent some explicit directive from Congress, . . . that treatment of foreign income at the federal level mandates identical treatment by the States.' [Citations.] Thus, a state tax at variance with federal policy will violate the 'one voice' standard if it *either* implicates foreign policy issues which must be left to the Federal Government *or* violates a clear federal directive [the second of these considerations being essentially a preemption analysis]." (Emphasis in original, 463 U.S. at p. 194 [77 L.Ed.2d at pp. 571-572].)

In applying this refinement of the one-voice standard, *Container* noted that the most obvious foreign policy implication of a state tax is the threat it might pose of offending foreign trading partners and leading them to retaliate against the nation as a whole. *Container*, however, said the judiciary has little competence in making these determinations on a theoretical basis, and even less competence in deciding how to balance a particular risk of retaliation against the sovereign right of the United States as a whole to let the states tax as they please. (463 U.S. at p. 194 [77 L.Ed.2d at p. 572].) The *Container* court emphasized that the nuances of foreign policy "are much more the province of the Executive Branch and Congress than of this Court." (*Id.*, at p. 196 [77 L.Ed.2d at p. 573].) According to *Container*, the best a court can do is try to develop objective standards that reflect general observations about international trade and relations. (*Id.*, at p. 194 [77 L.Ed.2d at p. 572].)

Container provided three reasons that weighed strongly against the possibility of justifiable and significant foreign retaliation. First, California's taxing method as applied to domestic-based unitary groups did not create an "*automatic* 'asymmetry' " in international taxation operating to a foreign entity's disadvantage. (Emphasis in original, 463 U.S. at pp. 194-195 [77 L.Ed.2d at p. 572].) Second, the method was imposed not on a foreign entity, as was the case in *Japan Line*, but on a domestic corporation. At this point, the *Container* court noted that a tax falling on a domestic corporation "might be less significant in the case of a domestic corporation that was owned by foreign interests," that is, the court again noted it was not dealing with the issue presented here. (*Id.*, at p. 195, including fn. 32 [77 L.Ed.2d at p. 572].) Third, even if foreign nations had a legitimate interest in reducing the tax burden of domestic corporations, that burden is more the function of tax rate than of allocation method, and California can simply raise its rate to achieve the same foreign economic effect. *(Ibid.)*

After stating that the threat of retaliation was not the only foreign policy implication a state tax may have, the *Container* court noted there was no amicus curiae brief from the executive branch opposing the tax (463 U.S. at p. 195 [77 L.Ed.2d at pp. 572-573]), and indicated that although the lack of such a brief was not dispositive, it did suggest that United States foreign policy was not seriously threatened by California's application of WWCR to domestic-based corporate groups. (*Id.*, at pp. 195-196 [77 L.Ed.2d at p. 573].)

After concluding that foreign affairs were not implicated by California's unitary tax in a domestic-based multinational context, the *Container* court inquired whether the tax violated a "clear federal directive." For the following reasons, no such directive was found.

There was no federal statute on point. While there were numerous tax treaties that committed the federal government to use an arm's length method in taxing the domestic income of multinational enterprises, that requirement was generally waived as to contracting nations taxing their own domestic corporations. This fact, if nothing else said the *Container* court, "confirms our

view that such taxation is in reality of local rather than international concern." (463 U.S. at p. 196 [77 L.Ed.2d at p. 573].) Those tax treaties did not generally cover the taxing activities of states, and in none of them did the requirement of arm's length accounting apply to the states. Moreover, the United States Senate had on one occasion declined to give its two-thirds consent to a treaty provision that would have prohibited the states from using WWCR. Finally, the court noted that Congress had long debated but not enacted legislation designed to regulate state taxation of income. In light of these circumstances, the court in *Container* could not conclude that California's unitary tax method, as applied to domestic-based unitary groups, was pre-empted by federal law or fatally inconsistent with federal policy. (463 U.S. at pp. 196-197 [77 L.Ed.2d at p. 573].)

Unlike *Japan Line* and *Container*, the United States Supreme Court in Wardair Canada v. Florida Dept. of Revenue, supra, 477 U.S. 1 [91 L.Ed.2d 1], did not engage in a dormant commerce clause analysis, finding it "abundantly clear" that the federal government had affirmatively acted rather than remained silent with respect to the issue there: the power of a state to tax all airline aviation fuel sold within the state regardless of the airliner's destination or the amount of intrastate business it did. (Pp. 9, 12 [91 L.Ed.2d at pp. 10, 12].)

In *Wardair*, the airliner and the United States as amicus curiae argued there was a federal policy prohibiting such an unlimited tax, a policy manifested by (1) the 1944 Chicago Convention on International Civil Aviation (1944 Convention), which the United States had signed; (2) a 1966 Resolution of the International Civil Aviation Organization (1966 Resolution), an organization to which the United States belonged; and (3) more than 70 bilateral aviation agreements, including the 1974 US-Canadian Aviation Agreement (Agreement). (Wardair was a Canadian airline.) The court in *Wardair* saw things much differently. Not only did this evidence fail to reveal any such policy, said the court, but showed the federal government had affirmatively acted to permit the tax at issue, thus precluding application of the dormant foreign commerce clause test enunciated in *Japan Line*. (477 U.S. at pp. 8-12 [91 L.Ed.2d at pp. 9-12].)

Wardair's analysis proceeded as follows. The 1944 Convention only prohibited the local taxation of aviation fuel " 'on board an aircraft . . . on arrival . . . and retained on board on leaving.' " (477 U.S. at p. 10 [91 L.Ed.2d at p. 11].) That provision, said the court, demonstrated the international community's awareness of the problem of state taxation of aviation fuel, and represented a decision by the Convention parties to address the problem by limiting only some of the localities' power to tax while implicitly preserving other aspects of that authority. (*Ibid.*) While the 1966 Resolution undeniably endorsed an international scheme to exempt fuel tax " ' "from all customs and other duties," ' " neither the executive nor the legislative branch had acted in any way to give the Resolution the force of law. (*Id.*, at pp. 10-11 [91 L.Ed.2d at p. 11].) And after the Convention came into force, the United States entered more than 70 bilateral aviation agreements, not one of which prohibited the states from imposing a tax like Florida's. (*Id.*, at p. 11 [91 L.Ed.2d at pp. 11-12].) The US-Canadian Agreement itself was limited to " 'national duties and charges,' " an especially striking feature given that (1) the Agreement was completed eight years after the 1966 Resolution specifically addressed the concern of subnational taxation, and (2) both signatories were federalist nations. (*Id.*, at pp. 11-12 [91 L.Ed.2d at pp. 12].) Moreover, throughout the duration of the Agreement, other American states and some Canadian provinces had imposed fuel taxes similar to Florida's without challenge, a course of conduct suggesting that the parties to the Agreement and those most immediately affected by it understood it to permit this taxation. (477 U.S. at p. 12 [91 L.Ed.2d at pp. 12].)

"What all of this makes abundantly clear," said the court in *Wardair*, is that the federal government has not remained silent but "[b]y negative implication" "has at least acquiesced" in the state taxation at issue. (477 U.S. at p. 12 [91 L.Ed.2d at pp. 12].) The dormant commerce clause test of *Japan Line* was deemed inapplicable because "the Federal Government ha[d] affirmatively decided to permit the States to impose these sales taxes on aviation fuel." (*Ibid.*)

Notable is the fact that the *Wardair* court continually reaffirmed the foreign dormant commerce clause test created in *Japan Line*, but failed to find an opportunity to employ it. Also notable is *Wardair's* recognition of the basic value underlying that clause: to "ensure that the essential attributes of nationhood will not be jeopardized by States acting as independent economic actors." (477 U.S. at p. 12; see also pp. 7-8 [91 L.Ed.2d at p. 12].) And the heightened importance of this value in the context of foreign commerce was recognized by *Wardair* when it stated: "In the unique context of . . . foreign commerce, we have alluded to the special need for federal uniformity: ' "In international relations and with respect to foreign intercourse and trade the people of the United States act through a single government with unified and adequate national power" ' [quoting *Japan Line, supra*, 441 U.S. at p. 448 [60 L.Ed.2d 336], quoting Board of Trustees v. United States (1933) 289 U.S. 48, 59 [77 L.Ed. 1025]." (477 U.S. at p. 8 [91 L.Ed.2d at p. 9].)

With the various holdings and analysis of the problems decided in *Japan Line, Container*, and *Wardair* in mind, we turn to the present context. The first issue to be resolved is whether the Board is correct that our case tracks *Wardair*, rendering a dormant commerce clause analysis unnecessary. For the reasons that follow, we think the Board is incorrect in its conclusion.

Preliminary, we reject the Board's suggestion that the three decisions, *Japan Line, Container*, and *Wardair*, together manifest a significant retrenchment in the sensitivity shown to foreign relations. Both *Container* and *Wardair* reaffirmed *Japan Line's* sensitivity to the unique context of foreign commerce and the special need for federal uniformity in international relations. To us, the theoretical underpinning has remained intact through these cases. What was different in them was the degree to which foreign affairs and international commercial relations were implicated. In *Japan Line*, the factual context presented an international asymmetry, an acute risk of retaliation, and varying degrees of international multiple taxation. By contrast, in *Container*, there was a minimal risk of retaliation, a largely domestic context, and executive branch silence; and in *Wardair*, both the American government and the Canadian government (the foreign country involved) had essentially agreed to permit the subnational taxation at issue. Far from demonstrating any significant retrench-

ment in the sensitivity shown to foreign relations, the three cases demonstrate how that sensitivity is aligned with the degree to which such relations are implicated.

Relying upon five perceived indications of executive and congressional acquiescence in light of the principles of *Wardair*, the Board contends an affirmative federal policy permitted California's use of WWCR. Those five factors are (1) the failure to consider state taxes in United States income tax treaties with foreign countries, except in nondiscrimination clauses; (2) the actions by the executive branch in adopting a Model Income Tax Treaty and in reserving its position on the Organization of Economic Cooperation and Development (OECD) Model Convention's application to subnational taxes; (3) Friendship, Commerce, and Navigation (FCN) Treaties to which the United States is a party do not require the states to use any particular method of tax accounting; (4) the absence of enacted congressional legislation prohibiting or restricting the states' use of WWCR; and (5) the rejection by the United States Senate of article 9(4) in the United States-United Kingdom Tax Treaty, the only attempt by the executive branch to alter federal acquiescence in the states' use of WWCR.

In analyzing the treaties and treaty actions encompassed in factor (1) through (3), we find little, if any, support for the Board's position. True, these treaties and actions reflect a *general* policy at the federal level of noninterference in state taxation, but they do so to preserve the *general* principle of state sovereignty. Not one of the treaties or actions, except for the U.S.-U.K. Tax Treaty to which we shall come, specifically addresses the unitary tax method or the use of WWCR by subnational units. The treaties either state in general terms that they apply to national taxes, or contain general provisions regarding subnational taxes. The reservations were made to model treaty provisions that state generally that the treaties should apply to subnational taxes. Moreover, it was not until the 1970's when use of WWCR in an international context essentially began that a problem of international dimension arose. (Cal. Code Regs., tit. 18, § 25137-6; see Comment, *California's Corporate Franchise Tax: Taxation of Foreign Source Income?* (1980) 20 Santa Clara L. Rev. 123,

131-136; hereafter 20 Santa Clara L.Rev.) Many of the treaties predate the existence of the problem and therefore do not discuss it.[4]

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[4]The Board chides the trial court for determining that pre-1978 tax treaties were largely irrelevant to this case. To support its position, the Board cites the 1924 United States Supreme Court decision in Bass, Ratcliff & Gretton v. State Tax Commission, 266 U.S. 271 [69 L.Ed. 282]. In *Bass*, the court constitutionally validated New York's application of a unitary business/formula apportionment method to the overall income of a British brewing company that imported a portion of its product through branch offices in New York and Chicago. Because of *Bass*, says the Board, the international community has been well aware since 1924 of this income allocation alternative to the AL/SA method.

Rather than support the Board's argument, we think *Bass* undermines it. Awareness of a particular tax theory is one thing; to be subjected to that theory in practice is quite another. Though *Bass* and its foreign-based unitary tax concept have been around since 1924, it was not until the early 1970's when the concept began to be noticeably *applied* that the problem of unitary taxation in the international arena arose. That history supports the idea that such a tax, though known as a concept, was little applied in international practice and thus largely irrelevant beyond our borders. (See Mobil Oil Corp. v. Commissioner of Taxes (1980) 445 U.S. 425, 438-439, 446-448 [63 L.Ed.2d 510]; *Container, supra*, 463 U.S. at pp. 163-165, 168-169, including fn. 7, 185-197 [77 L.Ed.2d 545].) All of this supports the trial court's eminently sensible determination that a tax treaty cannot be relevant to a tax problem that did not exist and was not foreseeable at the time the treaty was negotiated. Like judicial decisions, the older tax treaties here cannot sensibly be considered authority for propositions not considered.

In a somewhat related vein, the Board also cites *Bass* as constitutionally validating the unitary tax method as applied to foreign-based corporations. For a number of reasons, we disagree. First, *Bass* was decided before the United States developed its network of international tax treaties. (See 23 Columbia Journal at p. 450, fn. 32.) Second, *Bass* did not discuss foreign policy implications. Third, *Bass* obviously did not have the opportunity to apply the foreign dormant commerce clause test as enunciated in *Japan Line*. Finally and most importantly, *Container* cited *Bass* three times in passing yet twice explicitly reserved determining the constitutionality of the unitary tax method as applied to foreign-based corporate groups. (*Container, supra*, 463 U.S. at pp. 164-166, 189,

Contrast the treaty analysis in *Wardair.* There, the specific subject matter encompassing the tax at issue, as well as inextricably related taxes, had been discussed in the 1944 international Convention well before the aviation agreements were negotiated. Many of these agreements also postdated the 1966 international Resolution which specifically discussed the subject matter encompassing the tax. The American government and the international community were therefore negotiating these agreements with a keen awareness of the tax involved in *Wardair.* In fact, *Wardair* involved an issue of subnational taxation and the most relevant agreement in that case — the United States-Canadian Agreement — was signed by two federalist nations 30 years after the 1944 Convention and 8 years after the 1966 Resolution; furthermore, the course of conduct under this agreement indicated the tax at issue was permitted.

The Board's approach is simply too general and ignores historical context in essentially arguing that when a treaty is limited to national taxes or fails to discuss a particular taxation method, a conscious decision has been made to allow states to tax in *any* manner they please. Common sense charts a different course while respecting the broad power of a state to tax. (See Hines v. Davidowitz, supra, 312 U.S. at p. 68 [85 L.Ed. at pp. 587-588].)

In an attempt to be more specific, the Board does note that many of the bilateral tax treaties contain nondiscrimination clauses applicable to the states. The Board argues that these clauses give rise to a *Wardair*-like "negative implication" of a decision by the treaty parties to resolve the problem of state taxation by curtailing only some of the states' power to tax, while implicitly preserving other aspects of that authority. (*Wardair, supra,* 477 U.S. at pp. 10, 12 [91 L.Ed.2d at pp. 11, 12].) Again, we disagree.

In *Wardair,* the negative implication arose because foundation agreements had addressed not only the specific subject matter encompassing the tax at issue but specific taxes within that

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fn. 26, 195, fn. 32 [77 L.Ed.2d 545].) *Bass*'s importance fades considerably in light of these factors. (See 20 Santa Clara L.Rev. at pp. 126-128.)

subject, without addressing the tax at issue. Subsequent agreements were negotiated and conducted in the atmosphere of these foundational ones. The nondiscrimination clauses do not provide a similar parallel here. Those clauses are simply reflections of a general principle that a state shall not tax a foreign company more than it taxes its own companies. A *Wardair*-like negative implication concerning WWCR which arises from this generality is impossible.[5]

Also cloaked in generality is the Board's fourth factor that the Board asserts would preclude a dormant commerce clause analysis: the absence of enacted congressional legislation prohibiting or restricting the use of WWCR to foreign-based multinationals.

Apparently the Board concedes the trial court's finding that there was no evidence there has ever been a vote in a congressional committee or in Congress itself on legislation prohibiting the use of WWCR. And the senior career official in the Department of Treasury for WWCR matters during much of the 1970's and 1980's, George N. Carlson, testified that none of the proposed legislation dealt solely with WWCR as to foreign-based enterprises. It is also true, as reiterated in *Container,* that " 'Congress has long debated, but has not enacted, legislation designed to regulate state taxation of income.' " (463 U.S. at pp. 196-197 [77 L.Ed.2d at p. 573], quoting Mobil Oil Corp. v. Commissioner of Taxes, supra, 445 U.S. at p. 448 [63 L.Ed.2d at p. 528].)

The problem with this factor is that in trying to assign a specific reason to legislative inaction, we must enter the realm of pure speculation. It is difficult enough trying to ascertain legislative intent when a statute has been enacted, but trying to find meaning in legislative silence is about as difficult as hearing sound in a vacuum.

That brings us to the Board's fifth factor and the only one that specifically concerns the application of WWCR to foreign-based enterprises.

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[5]Our determination is supported by the fact that less tax-specific treaties such as the FCN Treaties contain a comparable nondiscrimination clause. (23 Columbia Journal at p. 471.)

In 1975 the executive branch negotiated an income tax treaty with the United Kingdom containing a provision — article 9(4) — that would have prohibited the states' application of WWCR to U.K.-based corporate groups. The United States Senate ratified the treaty only after article 9(4) was effectively removed through a reservation by Senator Church. The Board contends this senatorial action "was a significant indication of federal policy to let the states continue to use WWCR." Again, the Board simply reads too much into too little.

The Church reservation to article 9(4) was defeated in the Senate Foreign Relations Committee and again on the Senate floor. However, the treaty with article 9(4) included received a favorable full Senate vote of only 49 to 32, falling 5 votes short of the two-thirds majority needed for ratification. When the Church reservation was resurrected without a vote and the controversial article was effectively removed, the Senate then provided its constitutional imprimatur.

In light of these Senate tallies, it is difficult to see a congressional policy permitting states to use WWCR. Moreover, it appears that some of the senatorial opposition to article 9(4) was rooted not in the substance of the article but in the procedural wariness of addressing the problem through patchwork treaties rather than through comprehensive legislation.

The Board asks reasonably why no tax treaty subsequent to the U.S.-U.K. Tax Treaty has included a provision similar to article 9(4). The Board's answer is that the Senate action on 9(4) indicated a congressional policy permitting states to use WWCR. Our answer is that the constitutional high hurdle of treaty ratification and a treaty's piecemeal approach to the problem render a resolution via the treaty process ineffectual. We simply fail to see how three majority votes in the Senate essentially approving article 9(4) can be transmogrified into a *congressional policy* of disapproval.

Whether the Board's five factors are analyzed individually or collectively, they fall far short of establishing under *Wardair* an affirmative federal policy permitting California's use of WWCR. To the court in *Wardair* the factors there — an international

Convention, an international Resolution, and more than 70 post-Convention agreements, including the U.S.-Canadian Agreement and the course of conduct thereunder by its two federalist signatories — made it "abundantly clear" that the federal government had "affirmatively decided to permit the States to impose these sales taxes on aviation fuel." (477 U.S. at pp. 9-12 [91 L.Ed.2d at pp. 10-12].) That clarity was grounded in the close connection between those factors and the tax at issue, as the factors specifically discussed the subject matter of and taxes inextricably related to the tax at issue, or actually encompassed the type of tax at issue.

As we have seen, there is no similar connection between the factors cited by the Board and the WWCR taxation method at issue here. Only one of the Board's factors specifically addresses WWCR, and it does so in a manner that is at best neutral in respect to the Board's position. Interestingly, the court in *Container* had before it many of the same factors upon which the Board relies including the Senate action on the U.S.-U.K Treaty, and nevertheless engaged in a dormant commerce clause analysis. (463 U.S. at pp. 185-197 [77 L.Ed.2d at pp. 566-573].) Put most succinctly, while the court in *Wardair* was dealing with hard and specific evidence, we have been dealt "Five Easy Pieces." We proceed to a foreign dormant commerce clause analysis, applying the foreign dormant commerce clause test of *Japan Line* and *Container*.

1. *The Enhanced Risk of Multiple Taxation.*

This consideration need not detain us long. All of the elements of double taxation involved in *Container* are also involved here. (463 U.S. at pp. 189-193 [77 L.Ed.2d at pp. 568-571].) But *Container* rejected those elements, reasoning that they were not "inevitable" and that resorting to the AL/SA method would not guarantee their demise. (*Ibid.*) We can discern no constitutionally significant differences between domestic-based and foreign-based multinational corporations concerning the enhanced risk of multiple taxation: in neither case is double taxation inevitable. Following the precedent of *Container*, we find California's use of

WWCR as to foreign-based multinationals is not unconstitutional on this ground.

2. *Whether California's Application of WWCR to Foreign-Based Unitary Groups May Impair Federal Uniformity in an Area Where Federal Uniformity Is Essential and Prevents the Federal Government From Speaking With One Voice in International Trade.*

A. Foreign Policy Implications

The first issue to consider is whether California's application of WWCR to foreign-based unitary groups implicates foreign policy issues which must be left to the federal government. (*Container, supra*, 463 U.S. at p. 194 [77 L.Ed.2d at pp. 571-572]; see also *Japan Line, supra*, 441 U.S. at pp. 448, 453 [60 L.Ed.2d at pp. 347, 350].) We think that it does.

According to *Container*, "[t]he most obvious foreign policy implication of a state tax is the *threat it might pose* of offending our foreign trading partners and leading them to retaliate against the Nation as a whole." (Emphasis added, 463 U.S. at p. 194 [77 L.Ed.2d at p. 572].) Every single nation in the industrialized western world has sent letters to the United States government protesting the use of WWCR by American states. Many of these protests have also been directed to California. Among the most vigorous of these remonstrators has been Canada, by far the United States's largest trading partner, and Britain, this country's largest foreign investor. These protests have been sharp, frequent, and incessant over a number of years. There was also evidence that no other taxation issue had ever led foreign governments to deal directly with American states. Even high-placed officials of the Board acknowledged awareness of this international outcry. (See 20 Santa Clara L.Rev. at pp. 125-126.)

And it is not just talk. The ultimate test of diplomatic sincerity — watch what they do, not what they say — has been met here. In 1985, Britain passed retaliatory legislation withdrawing a tax advantage for U.S.-based corporations doing business in both Britain and a unitary tax state. Though Britain stopped short of pulling the procedural trigger to fully implement this legislation,

the law had a retroactive provision that impelled many American companies into preimplementation compliance. Moreover, Britain cancelled a trade mission to Florida because that state applied WWCR to foreign-based multinationals. And there were other similar cancellations. There was also evidence the United States has had problems in negotiating treaties because of objections to WWCR.

The Board claims Britain has orchestrated the international outcry and passed a disingenuous piece of "retaliatory" legislation that does not retaliate. However, some nation has to take the lead and the often-noted "special relationship" between Britain and the United States makes Britain the obvious choice for conductor. We doubt that every industrialized country in the western world would have joined the symphony if there were not truly a significant problem. In fact, a committed leader is more likely, not less likely, to be genuinely devoted. As to the allegedly devious legislation, Britain, the largest foreign investor in the United States, stood to lose disproportionately if America deemed that legislation completely unfounded. Many American companies operating in Britain did not believe such legislation was merely for show. Moreover, the legislation was introduced "back-bench," that is, by the opposition party, and nevertheless passed unanimously — extraordinary legislative feats according to the bill's author.

Our views are buttressed by analyzing the three general factors identified in *Container* that "might justifiably lead to significant foreign retaliation." (463 U.S. at pp. 194-195 [77 L.Ed.2d at p. 572].) The first factor is whether California's use of WWCR creates an automatic asymmetry in international taxation operating to the foreign-based multinational's disadvantage. Because no other country in the world uses WWCR, domestic-based multinationals do not face this taxation method abroad. And while both domestic and foreign-based multinationals are subjected to the method if they do business in an American jurisdiction that employs it, the administrative burdens of compliance, as we shall see, fall much harder on the foreigner.

The second general factor identified in *Container* inquires whether the legal incidence of the tax falls on a domestic

corporation or a foreign one. (463 U.S. at p. 195 [77 L.Ed.2d at p. 572].) This factor was of significant importance in *Container*, being noted at four places in the opinion. (*Id.*, at pp. 188-189, 195, including fns. 26, 32 [77 L.Ed.2d at pp. 568-569, 572].) We face here the precise issue reserved in *Container*: "the constitutionality of combined apportionment with respect to state taxation of domestic corporations with foreign parents or foreign corporations with either foreign parents or foreign subsidiaries." (*Id.*, at p. 189, fn. 26 [77 L.Ed.2d at p. 568].) *Container* carefully noted that the tax there was imposed on a domestic corporation, "not on a foreign entity as was the case in *Japan Line*," and that "[a]lthough, California 'counts' income arguably attributable to foreign corporations in calculating the taxable income of that domestic corporation, the legal incidence of the tax falls on the domestic corporation." (*Id.*, at p. 195 [77 L.Ed.2d at p. 572].) *Container* also recognized "that the fact that the legal incidence of a tax falls on a corporation whose formal corporate domicile is domestic might be less significant in the case of a domestic corporation that was owned by foreign interests." (463 U.S. at p. 195, fn. 32 [77 L.Ed.2d at p. 572].)

Here, California's taxation method of WWCR falls directly on a domestic corporation with a foreign parent (Barcal) and directly on a foreign corporation with a foreign parent and foreign subsidiaries (BBI). As we have seen, foreign governments are none too happy about this state of affairs. The governments of Britain and Canada have expressed their displeasure to this court through their amici curiae briefs.

Proponents of the worldwide unitary tax method cannot dispel foreigners' concerns by arguing that it is really the United States subsidiary or operation that bears the tax burden. The premise of the unitary tax system is that it is unrealistic geographically to isolate income derived from the intangible flow of value among the parts of a unitary business. Similarly, then, it is unrealistic to isolate the tax payments necessitated by that system: the incidence of taxation falls on the entire business, including the foreign parent. (See 23 Columbia Journal at p. 466.)

That brings us to the third general factor identified in *Container* as bearing on the risk of foreign retaliation: whether the tax

burden is more a function of California's WWCR tax rate or its allocation method. (463 U.S. at p. 195 [77 L.Ed.2d at p. 572].)

Foreign-based corporate groups incur significantly greater administrative costs to comply with California's WWCR system than do their domestic-based counterparts; in fact, all of the trial witnesses agreed that literal compliance with the system was cost-prohibitive for the foreign groups.[6] (See Comptroller General Report, *Key Issues Affecting State Taxation of Multijurisdictional Corporate Income Need Resolving*, 3, GAO/GGD-82-38 (1982) [hereafter, GAO Report].)

In a nutshell, this distinction between domestic and foreign-based multinationals is a result of the following: while domestic-based multinationals keep most of their records in English, in United States currency and in accord with United States accounting principles, the same cannot be said for multinationals based abroad. (GAO Report at p. 39.) For the foreign parent, some of the information may not be available because different nations use different accounting methods. Obviously, the information that does exist is not always in the language, in the currency, and in accord with the principles just noted. Substantial costs are incurred in obtaining the necessary information and translating and transforming it to these modes. (See 20 Santa Clara L.Rev. at pp. 143-144; 23 Columbia Journal at p. 471.)

The administrative nightmare for the foreign-based multinational is aptly demonstrated here. In 1977, BBI, a Britain-based company, was engaged in business directly or through subsidiaries in approximately 55 countries. During this time, BBI had an interest sufficient for California unitary group purposes, in more than 70 subsidiaries operating in approximately 34 countries outside Britain. Two of those subsidiaries were organized and operated in the United States: Barcal and Barclays Bank of New

[6]The Board contends the trial court should have excluded all evidence on cost of compliance because plaintiffs failed to adequately raise the issue in administrative proceedings. We disagree. Plaintiffs' original and supplemental protests raise the compliance issue as part of their overall constitutional challenge. Moreover, the Board was apprised of this issue in correspondence during the administrative process.

York (BBNY). In addition to owning BBI and BBI's subsidiaries, BBL, the Britain-based ultimate corporate parent, owned a sufficient interest for California unitary purposes in over 140 subsidiaries that operated outside the United States. All told then, the Barclays unitary group consisted of over 220 subsidiaries (including subsidiaries of subsidiaries)operating in some 60 countries, but of these only BBI, Barcal, and BBNY, did business in the United States.

Using the Board's own figures, only 1.5 percent of the income generated by the Barclays group worldwide in 1977 can be attributed to California. Even accounting for the BBNY activity, this means that over 98 percent of the Barclays group's income in 1977 had its source outside the United States. According to witnesses at trial, it would cost millions of dollars for Barclays to establish and maintain the global system necessary to literally comply with California's WWCR tax method. (The figures ranged from \$6.4 million to \$7.7 million to establish the system, and from \$2 million to \$3.8 million a year to maintain it.) And note that Barclays, unlike many other foreign multinationals, at least speaks the same language as the California taxing authorities.

That it is California's allocation method rather than its tax rate that is the primary source of difficulty becomes readily apparent when these kinds of circumstances are viewed by foreign entities steeped in the AL/SA tradition. Foreign anger is even more understandable in light of the critical role the United States has played in attempting to construct a coherent and nondiscriminatory tax policy for all nations based on the AL/SA method. (See 23 Columbia Journal at pp. 459-462; 20 Santa Clara L.Rev. at pp. 153-154.)

The trial court deemed these costs of compliance sufficient to invalidate WWCR as an unconstitutional discrimination against foreign commerce — i.e., as a breach of one of the original four tests set forth in *Complete Auto* (430 U.S. 274 [51 L.Ed.2d 326]). While we do not here use costs alone to constitutionally invalidate the use of WWCR (see *Bibb v. Navajo Freight Lines* (1959) 359 U.S. 520, 526 [3 L.Ed.2d 1003, 1008]), this legal analysis by the trial court — based upon a factual foundation of

substantial evidence — demonstrates just how serious the administrative burden can be for the foreign entity.

The Board argues that literal compliance is a nonissue because regulations have been adopted by which a foreign-based multinational can use reasonable approximations to figure its California tax. (Cal. Code Regs., tit. 18, § 25137-6; Rev. & Tax Code, § 25137.) These approximations, according to the Board, can be derived from annual reports and other data that are already publicly available. (See 23 Columbia Journal at p. 472.)

There are several problems with the Board's argument. The Board decides whether to allow a foreign entity the route provided by regulation 25137-6, and such discretion is a powerful instrument in light of the cost-prohibitive alternative of literal compliance. Moreover, California state tax authorities have at least once threatened to impose penalties for failure to produce detailed information needed to apportion income, even though the British-based company involved claimed the information was confidential under Britain's national security laws. (See *EMI Ltd. v. Bennett* (N.D.Cal. 1982) 560 F.Supp. 134; *Capitol Industries — EMI, Inc. v. Bennett* (9th Cir. 1982) 681 F.2d 1107, 1110-1111; 23 Columbia Journal at p. 472.) These tax authorities cannot maintain on the one hand that reasonable approximations derived from already publicly available data are sufficient, and on the other hand demand under sanction more detailed information that is not readily available or even producible. Logically, detailed information on payroll, property, and sales is needed to apply the WWCR formula in an uncapricious manner. But more fundamental is why a state which has so little faith in the AL/SA method would so willingly embrace another method that is based on approximations derived from very general data? In light of these observations, the practical availability of the reasonable approximation approach is seriously open to question.

In contrast to *Container* then, we do not have to speculate on whether the taxation method at issue may offend our foreign trading partners and lead them to retaliate against the nation as a whole. (463 U.S. at p. 194 [77 L.Ed.2d at p. 572].) They are offended; they have retaliated. And the three general factors identified in *Container* that might justifiably lead to significant

retaliation — asymmetry, upon whom the tax falls, and tax rate versus allocation method — are all present in this case. (*Id.*, at pp. 194-195 [77 L.Ed.2d at p. 572].)

Also in marked contrast to *Container* stands the amicus curiae brief from the federal executive branch opposing California's application of WWCR to foreign-based corporate groups. That brief reiterates many of the points noted above and delineates an executive branch policy we will discuss below. We are mindful of *Container's* observation that in the context of the foreign commerce clause the foreign policy nuances of the United States are much more the province of the executive and the Legislature than of the judiciary. (463 U.S. at pp. 195-196 [77 L.Ed.2d at pp. 572-573].)

B. Clear Federal Directive

That brings us to the other avenue identified in *Container* by which a state tax will violate the "one-voice" standard: if the tax violates a clear federal directive. (463 U.S. at p. 194 [77 L.Ed.2d at pp. 571-572].) As this consideration is an integral component of the dormant commerce clause test, obviously such a directive is not synonymous with an affirmative federal policy precluding dormant commerce clause analysis. (*Id.*, at pp. 193-194 [77 L.Ed.2d at p. 571].)

In dealing with this issue, the court in *Container* looked for specific indications of congressional intent after noting that no amicus brief from the executive branch had been filed. (463 U.S. at pp. 195-196 [77 L.Ed.2d at pp. 572-573].) Examining much of the same evidence relied on by the Board here to preclude a dormant commerce clause analysis, *Container* did not find any such indications and concluded that California's application of WWCR to domestic-based corporate groups was not preempted by federal law or fatally inconsistent with federal policy. (*Id.*, at pp. 196-197 [77 L.Ed.2d at p. 573].)

Like the court in *Container*, the trial court in this instance found "no Congressional expression either way on this subject." Our earlier discussion as to why *Wardair* does not preclude a dormant commerce clause analysis supports this finding.

However, the trial court found the evidence unequivocal "that the executive branch all along, under three administrations since the WWCR problem in the present context became known, has steadfastly adhered to a policy of use of the arms length/separate accounting (AL/SA) method and not WWCR, both as to the States and the Federal Government." In the context presented here, we agree with the trial court.

George Carlson, who was the Treasury Department's (the executive department charged with formulating tax policy) senior career official for WWCR issues during most of the 1970's and 1980's, testified regarding the executive branch's policy on WWCR application to foreign-based corporate groups. That policy was officially pronounced in 1975 when the U.S.-U.K. Tax Treaty was signed, and essentially proscribed such an application while advocating an accounting restriction to the "water's-edge" of the United States. The genesis of the policy can be found in Treasury Department studies confirming complaints from foreign governments about increased risks of double taxation, disproportionate administrative burdens, and possible retaliation. Additionally, those studies found that WWCR in a foreign context was interfering with the federal government's foreign commercial policy and its ability to negotiate bilateral tax treaties. In short, the Treasury Department — again, the executive department charged with formulating the executive branch's tax policy — concluded that WWCR was an irritant in our foreign commerce relations.

This executive policy remained constant through four presidential administrations, starting when negotiations on the U.S.-U.K. Tax Treaty began, to the point when this case was litigated. And though there was a change in political party of the executive during this time, there was no change in policy: the executive branch did not want WWCR applied to foreign-based corporate groups.

Negotiations on the U.S.-U.K. Tax Treaty began during President Nixon's administration.

That treaty, with article 9(4) included, was signed during President Ford's tenure.

President Carter's Secretary of the Treasury, Michael Blumenthal, in a 1977 letter to Martin Huff, then the executive director of the Board, stated: "The unitary apportionment system is inconsistent with accepted tax treaty policy which prohibits one country from taxing the business profits of an enterprise of the other unless that enterprise is engaged in business through a permanent establishment in the first country.... [¶] ... The arm's length standard is the internationally accepted approach." And President Carter's Assistant Secretary of the Treasury for Tax Policy, Donald Lubick, explained the administration's position to both houses of Congress in March and June of 1980. Lubick emphasized that WWCR application to foreign-based corporate groups was the preeminent concern, citing the firmly-documented problems of foreign policy interference, double taxation, administrative burdens, and possible retaliation.

Faced with a deluge of complaints from all of our major trading partners and his patience exhausted by the failure of the states to resolve the WWCR problem voluntarily, President Reagan in 1985 publicly issued a directive on the matter. He instructed the Attorney General to pursue through litigation and the Secretary of the Treasury to pursue through legislation and where appropriate, through treaty amendment, the federal policy that multinational corporations be taxed by states only on income derived from the United States and not on income derived from foreign subsidiaries. Under the aegis of that directive, Secretary of State Schultz in early 1986 wrote to Governor Deukmejian urging him to support efforts to end California's use of WWCR. Not only did this letter explain that it was the long-standing policy of the United States to follow the AL/SA method, which was also the international standard, but that, "[y]our state's employment of the worldwide unitary method of tax accounting is at odds with the position of the United States and has become a source of conflict with foreign states;" furthermore, the letter pointed out that "[t]he worldwide unitary issue has seriously complicated our economic relations with many of our closest allies." California passed the "water's-edge" legislation a few months later.

On this record we feel confident in saying that the executive branch has spoken clearly. Through that branch, the policy of the

United States since the WWCR problem in the present context arose in the 1970's has been established: WWCR is not to be applied to foreign-based corporate groups — those groups are to be taxed by the states only on income derived from the United States.

Naturally, the question arises as to whether the executive branch alone can establish national policy in the field of foreign commerce or does it need the concurrence of the legislative branch?

Undoubtedly, the legislative branch can establish national policy in the field of foreign commerce without the concurrence of the executive branch. Specifically, the federal Constitution grants Congress this power (U.S. Const., art. I, § 8, cl. 3).

Does the same obtain for the executive branch? In the steel industry seizure case of Youngstown Sheet & Tube Co. v. Sawyer (1952) 343 U.S. 579 [96 L.Ed. 1153], Justice Jackson wrote a concurring opinion analyzing the scope of presidential power. (343 U.S. at pp. 634-656 [96 L.Ed. at pp. 1198-1210].) It has been said that Jackson's opinion "brings together as much combination of analysis and common sense as there is in this area, ..." (See Dames & Moore v. Regan (1981) 453 U.S. 654, 661 [69 L.Ed.2d 918, 929].) In that opinion, Jackson set forth the following tripartite framework as a guide in resolving issues involving presidential power: "1. When the President acts pursuant to an express or implied authorization of Congress, his authority is at its maximum, for it includes all that he possesses in his own right plus all that Congress can delegate. In these circumstances, and in these only, may he be said (for what it may be worth) to personify the federal sovereignty.... A seizure executed by the President pursuant to an Act of Congress would be supported by the strongest of presumptions and the widest latitude of judicial interpretation, and the burden of persuasion would rest heavily upon any who might attack it. [¶] 2. When the President acts in absence of either a congressional grant or denial of authority, he can only rely upon his own independent powers, but there is a zone of twilight in which he and Congress may have concurrent authority, or in which its distribution is uncertain. Therefore, congressional inertia, indifference or quiescence may

sometimes, at least as a practical matter, enable, if not invite, measures on independent presidential responsibility. In this area, any actual test of power is likely to depend on the imperatives of events and contemporary imponderables rather than on abstract theories of law. [¶] 3. When the President takes measures incompatible with the expressed or implied will of Congress, his power is at its lowest ebb, for then he can rely only upon his own constitutional powers minus any constitutional powers of Congress over the matter. . . . Presidential claim to a power at once so conclusive and preclusive must be scrutinized with caution, for what is at stake is the equilibrium established by our constitutional system." (Fns. omitted, 343 U.S. at pp. 636-638 [96 L.Ed. at pp. 1199-1200].)

Based upon our previous analysis, the executive action here aligns with Justice Jackson's second category. And as noted by Justice Jackson, it is the imperative of events and contemporary imponderables rather than abstract theories of law that primarily guides our review.

We begin by emphasizing the field in which the executive branch has acted: foreign policy. That is a field in which the executive possesses substantial power of its own. (See United States v. Curtiss-Wright Export Corp., supra, 299 U.S. at pp. 319-320 [81 L.Ed. at pp. 262-263]; United States v. Belmont, supra, 301 U.S. 324 [81 L.Ed 1134]; United States v. Pink (1942) 315 U.S. 203 [86 L.Ed. 796]; *Container, supra*, 463 U.S. at pp. 165-166 [77 L.Ed.2d at p. 553]; U.S. Const., art. II, §§ 1, 2.) Although the Constitution grants to Congress the power to regulate commerce with foreign nations, the executive's rightful power in the foreign policy arena inextricably involves international commercial relations. *(Container, supra.)*

Particularly is this true in this era of increasingly "globalized" and rapidly changing economic forces, and the beginnings of economic displacement of military competition in big power relations. The rapidity with which global changes in economic structure are occurring places an imperative on the exercise of swift and effectual national power, the kind of power most suitably exercised by the executive. Recall *Wardair*'s reiteration that " '[i]n international relations and with respect to foreign

intercourse and trade the people of the United States act through a single government with unified and adequate national power.' " (477 U.S. at p. 8 [91 L.Ed.2d at p. 9], quoting *Japan Line, supra*, 441 U.S. at p. 448 [60 L.Ed.2d at p. 347], quoting Board of Trustees v. United States, supra, 289 U.S. at p. 59 [77 L.Ed. 1025].)

If Congress were to enact legislation or take some other affirmative action contrary to the executive branch policy, that would most likely be the end of the matter. But Congress must act as a consensual body before a legislative policy can be discerned. Before that happens, the legislative branch, in contrast to the executive branch, resembles more a cacophony than a chorus of voices, each legislator having his or her own reason for speaking. As detailed earlier, we discern no congressional policy regarding the states' use of WWCR.

We are mindful of the Board's concern about unbridled executive power and about national policy being nothing more than what the executive says it is. Again, however, we must emphasize that we are dealing with a critical foreign policy issue on which the executive has affirmatively acted and the Congress has not. Nor would it have been difficult for the Congress to act: one simple sentence in a piece of legislation, a treaty, or a resolution would have sufficed.

The evidence here reveals that as soon as the problem of WWCR in an international context arose, executive departments began studying the issue. Those studies confirmed the validity of the complaints from foreign governments and culminated in the official and public expression of executive branch policy in 1975 with the signing of the U.S.-U.K. Tax Treaty. In a nutshell, that policy sought the elimination of WWCR as applied to foreign-based corporate groups, and an accounting restriction to the "water's-edge" of the United States. The policy has never wavered though the party affiliations of the administrations continuing it have. In fact, through the years, the policy has grown stronger: the Reagan administration sought to eliminate WWCR as applied not only to foreign-based multinationals, but to domestic-based ones as well.

Public expressions of the executive policy have been made continuously since the mid-1970's. Even the executive director of the Board was explicitly informed by President Carter's Secretary of the Treasury in 1977 that the unitary apportionment system was inconsistent with accepted tax treaty policy — i.e., with the AL/SA method. And one cannot doubt the clarity of the executive's position.

In this context, it is unnecessary to fret about national policy being formulated through executive whim. Found here is a clear, continuous, and thoroughly-grounded policy developed by the executive branch in the face of congressional inertia and inaction, and directly involving an issue — foreign policy — to which great deference to the executive has traditionally been given. (See United States Curtiss-Wright Export Corp., supra, 299 U.S. at pp. 319-320 [81 L.Ed. at pp. 262-263]; Container Corp. v. Franchise Tax Bd., supra, 463 U.S. at pp. 195-196 [77 L.Ed.2d at pp. 572-573].) This context also strikes the proper balance between the purposes of the commerce clause — to avoid "economic balkanization," promote free trade and prevent individual states from working to the detriment of the nation as a whole — and the legitimate interest of the states in exercising their taxing power. (See Boston Stock Exchange v. State Tax Comm'n (1977) 429 U.S. 318, 328-329 [50 L.Ed.2d 514, 523-524]; National Meat Ass'n. v. Deukmejian (9th Cir. 1984) 743 F.2d 656, 659.) While we realize that a state's power to tax is bottomed on a broad base, we cannot ignore that California's application of WWCR to foreign-based corporate groups directly affects international relations. (See Hines v. Davidowitz, supra, 312 U.S. at p. 68 [85 L.Ed. at pp. 587-588]; Zschernig v. Miller (1968) 389 U.S. 429 [19 L.Ed.2d 683]; Bethlehem Steel Corp. v. Board of Commissioners (1969) 276 Cal.App.2d 221; Amarel v. Connell (1988) 202 Cal.App.3d 137.)

We must also emphasize that our determination has little to do with the technical merits of the WWCR method in the abstract. Theoretically, that method may very well be a superior one were it to be applied fairly by nations around the globe. But the international community is presently enmeshed in the tradition of separate accounting, a tradition largely engendered through

American efforts. When an American state in isolation employs a method which radically departs from that tradition and which demands an accounting of foreign corporations that have nothing to do with the state or with the United States for that matter, the adverse implications for American foreign policy are not hard to imagine.

We hold that California's unitary tax method (worldwide combined reporting, WWCR) as applied to foreign-based unitary groups is unconstitutional under the foreign commerce clause of the federal Constitution because it not only implicates foreign policy issues which must be left to the federal government but violates a clear federal directive as well. (*Container, supra,* 463 U.S. at p. 194 [77 L.Ed.2d at p. 571].)

The Board argues that even if this application of WWCR is unconstitutional under the foreign commerce clause today, such a determination is irrelevant to its constitutionality in 1977. We disagree for two reasons.

First, we have determined the trial court was correct in finding that the executive branch since 1975 has clearly and consistently opposed applying WWCR to foreign-based corporate groups. Second, and more importantly, the "one-voice" standard of *Japan Line* and *Container* does not depend on the outcome of events for its application. In applying that test, the courts inquire whether a state tax "*may* impair federal uniformity in an area where federal uniformity is essential" (emphasis added, *Japan Line, supra,* 441 U.S. at p. 448 [60 L.Ed.2d at p. 347]); and they analyze "the *threat* [the tax] *might* pose of offending our foreign trading partners and leading them to retaliate against the Nation as a whole" by employing general standards to see if the tax "*might* justifiably lead to significant foreign retaliation." (Emphasis added, *Container, surpa,* 463 U.S. at p. 194 [77 L.Ed.2d at p. 572.) In short, the judiciary asks whether the probability of justifiable, adverse foreign response and actions is too strong to permit the state tax to stand. This judicial application of the foreign commerce clause thus aligns with the underlying premise of the clause: to "commit[ ] to the exclusive authority of the Federal Government the regulation of those aspects of foreign commerce that *by their very nature* 'necessitate a uniform national rule.' "

(Emphasis added, Wardair Canada v. Florida Dept. of Revenue, supra, 477 U.S. at p. 18 [91 L.Ed.2d at p. 16] [dis. opn. of Blackmun, J.], quoting *Japan Line, supra,* 441 U.S. at p. 449 [60 L.Ed.2d at p. 348].)

As the trial court aptly noted in this regard, "[t]his case factually demonstrates as extreme an example of predictable international consequences stemming from a local tax as can be conceived." Succinctly stated, the Board required the Britain-based Barclays group, which derived over 98 percent of its income from business activity outside the United States, to supply detailed accounting information on all of its more than 200 subsidiaries operating in some 60 countries because the group did a little over 1 percent of its business in California. In light of the custom of nations making AL/SA the international standard, the radical differences between AL/SA and WWCR, and the distinctions between this case and *Container*, a direct, adverse impact on foreign affairs was inevitable. The international furor that resulted was justified and therefore entirely predictable.

The Board unnecessarily worries whether such a holding would subject a state's power to tax to the mercy of a foreign government's vocal chords. Our opinion has made clear, substantially more than mere complaints are involved in this case. The essentials of the dilemma were concisely summarized by one witness at the U.S.-U.K. Tax Treaty hearings: "To permit them [the states] to roam the world threatening U.K. based companies having no permanent establishment in the U.S., demanding information which the U.S. would have no treaty right to demand, and generally acting like a bull in the international china shop, is unbecoming to the dignity of the U.S., to the placidity of its relations with those countries with which it solemnly negotiates treaties, and accomplishes no purpose necessary for the protection of the revenue of the taxing states." (23 Columbia Journal at p. 467.)

Having decided that California's application of WWCR (Rev. & Tax. Code, § 25101) to foreign-based unitary groups is unconstitutional under the foreign commerce clause of the federal Constitution, it is unnecessary for us to consider the plaintiffs' due process challenge.

The judgment is affirmed. *(CERTIFIED FOR PUBLICATION.)*

EVANS, J.*

We concur:

PUGLIA, P.J.

DAVIS, J.

* Assigned by the Chief Justice.

APPENDIX C

IN THE SUPREME COURT OF
THE STATE OF CALIFORNIA

BARCLAYS BANK INTERNATIONAL, LTD.,
Plaintiff and Respondent,
v.
FRANCHISE TAX BOARD,
Defendant and Appellant.

BARCLAYS BANK OF CALIFORNIA,
Plaintiff and Respondent,
v.
FRANCHISE TAX BOARD,
Defendant and Appellant.

S019064
Ct. App. No. C003388
Sacto. Super. Ct.
Nos. 325059 and 352061

Supreme Court Filed May 11, 1992

Robert Wandruff Clerk
DEPUTY

We granted review to decide whether the use by the state Franchise Tax Board of a three-factor formula to apportion the income of a foreign-parent multicorporate unitary enterprise for state tax purposes violates the foreign commerce clause of the federal Constitution (art. I, § 8, cl. 3). We conclude that relevant treaty and other materials manifest a federal intent not to prohibit the states from employing formula apportionment in taxing the income of such a multinational unitary business. We therefore reverse the judgment of the Court of Appeal.

I

Plaintiff taxpayers, Barclays Bank of California and Barclays Bank International, Ltd. (collectively, the Bank), brought this refund action to recover assessments of $152,420 and $1,678 levied against them by the Franchise Tax Board (Board) for the 1977 tax year. The basis for the assessments was a finding by the Board that, together with their United Kingdom-based corporate parent and related worldwide subsidiaries, the Bank comprised a unitary enterprise, thereby subjecting it to the three-factor mathematical formula used by the Board to apportion the interjurisdictional income of a unitary business for state corporate income tax purposes.[1] Although the Bank did not contest the Board's predicate finding of corporate unity, it did claim that application of California's apportionment formula to such a unitary group — that is, one whose corporate parent is a foreign domiciliary — violates the foreign commerce clause of the federal Constitution.

Following a bench trial, the superior court ruled in favor of the Bank; the Court of Appeal affirmed, holding that California's

[1]During 1977, the tax year at issue here, Revenue and Taxation Code section 25101 provided in relevant part: "When the income of a taxpayer subject to the tax imposed under this part is derived from or attributable to sources both within and without the state the tax shall be measured by the net income derived from or attributable to sources within this state in accordance with the provisions of Article 2 (commencing with Section 25120 of this chapter); . . ."

Section 25120 et seq. of the Revenue and Taxation Code is California's version of the Uniform Division of Income for Tax Purposes Act (UDITPA; see 7A West's U. Laws Ann. (1985) p. 331); as explained more fully later in this opinion, the statute authorizes the use of a three-factor formula to apportion the net income from a taxpayer's total business activities in order to determine the net income attributable to intrastate activities. (See *post*, p. ___ et seq. [typed maj. opn. p. 5 et seq.]; Rev. & Tax. Code, §§ 25120-25140.)

In this opinion, we sometimes use the term "formula apportionment" as a shorthand description of this three-factor mathematical formula employed by the Board to apportion for state tax purposes the interjurisdictional income of a worldwide or domestic unitary enterprise.

formula apportionment method was unconstitutional as applied to foreign-based unitary groups. In the view of the Court of Appeal, use of the Board's method in such a case violated the foreign commerce clause in two respects. First, its application to a so-called "foreign parent" unitary business implicated foreign policy issues that were constitutionally required to be left to the federal government. Second, use of the formula apportionment method in the Bank's case was at odds with a clear federal directive embodied in presidential and cabinet-level statements, letters, and press releases, task force reports and the congressional testimony of senior executive officials to the effect that American foreign commercial policy supported the use of an alternative accounting method to determine the taxable income of foreign-based corporations, one that is incompatible with formula apportionment.

As the Court of Appeal recognized, this suit is not the first litigation challenging on foreign commerce clause grounds the Board's use of a three-factor formula to apportion the worldwide income of a multinational enterprise. In *Container Corp. v. Franchise Tax Bd.* (1983) 463 U.S. 159 (*Container*), the United States Supreme Court sustained against foreign commerce clause challenge the Board's use of formula apportionment to determine the taxable income of a *domestic*-based unitary business group with foreign-domiciled subsidiaries. Despite the outcome in *Container*, the Bank successfully contended before the Court of Appeal that issues implicated by its foreign parentage are dispositive of the constitutional question and compel the opposite result in this case.

Although presented with a question left open in *Container* (*supra*, 463 U.S. at p. 189, fns. 26 & 32), we approach its resolution along a path illuminated by the high court's analysis in a series of recent opinions, *Container* among them, in the contemporary evolution of the "dormant foreign commerce clause" doctrine. Our opinion has two parts. As a prelude to the constitutional question, we first examine the extralegal issues raised by competing methodologies used to distribute multijurisdictional corporate income for state tax purposes; we then address the Bank's central contention that a dormant foreign commerce clause analysis is appropriate here and that the Board's applica-

tion of formula apportionment to the Bank's unitary business does not survive that analysis.

As we explain, neither of the two competing models used to allocate interjurisdictional income for state tax purposes is demonstrably superior to the other, even in an international multicorporate setting. Both methods meet the constitutional standard of avoiding "unreasonably" attributing extrastate value to the taxing jurisdiction. Moreover, the high court's recent foreign commerce clause jurisprudence reflects a diminution in the reach of dormant foreign commerce clause analysis in favor of an expanded recognition that, under circumscribed conditions, governmental silence may constitute a ratification of state taxation of foreign commerce, rendering a dormant analysis inapposite. In our view, this is such a case.

II

Background: State Taxation of International Income

A

Limitations on taxation by the states of the income of corporations doing business in more than one jurisdiction inevitably implicate the sufficiency of quantitative measures used to identify that portion of taxable value reasonably attributable to the taxpayer's intrastate activities. This pivotal role of technique arises from the stricture of the commerce and due process clauses of the federal Constitution that "a State may not tax value earned outside its borders." (*ASARCO Inc. v. Idaho State Tax Comm'n* (1982) 458 U.S. 307, 315 (*ASARCO*).) To meet this limitation, state tax schemes must comply with multiple criteria designed to produce a substantially accurate distribution of income so that only "values created by business within its borders" are taxed. (*Butler Bros. v. McColgan* (1942) 315 U.S. 502, 507 (*Butler Bros.*).)

Two distinct models have long competed for supremacy in identifying the required division of multijurisdictional income. One model, known as the "arm's length/separate accounting" or "AL/SA" method, calculates income on a discrete and circum-

scribed basis, whether geographical, transactional, or functional. In a multicorporate interjurisdictional setting, the AL/SA method allocates income to a single taxing "sovereign" rather than apportioning it among jurisdictions, and treats intercorporate transfers of value between commonly held or related entities as if they were "arm's length" transactions between unaffiliated businesses. There seems little reason to doubt that, as an operational matter, the AL/SA model is the dominant method employed by corporations both in the United States and internationally; that is, a majority of businesses use the AL/SA or a variant method for their *own* internal accounting purposes.

The competing model for taxation purposes is the "unitary business/formula apportionment" method. Founded on the perception that "[i]n the case of a more-or-less integrated business enterprise operating in more than one State . . . arriving at precise territorial allocations of 'value' is often an elusive goal, both in theory and in practice" (*Container, supra*, 463 U.S. at p. 164), formula apportionment relies on mathematical generalization to distribute an aliquot share of income or taxable value among taxing jurisdictions. The dominant variation of formula apportionment — the so-called "three-factor" model employed by the Board in this case — defines the multijurisdictional scope of the unitary enterprise of which the taxable intrastate activities are a part, calculates the combined income of the components of the unitary group, and distributes a portion of that result to the taxing state using a mathematical formula based on an averaged ratio of property, payroll, and sales in the taxing jurisdiction to that of the unitary enterprise overall.[2] (See *Container, supra*, 463 U.S. at p. 165.)

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[2]Thus, the taxable income of a multijurisdictional unitary taxpayer in a state using the three-factor variant of formula apportionment would be calculated under the following equation:

$$\frac{\frac{\text{In-state Property}}{\text{Total Property}} + \frac{\text{In-state Payroll}}{\text{Total Payroll}} + \frac{\text{In-state Sales}}{\text{Total Sales}}}{3} \times \begin{array}{c}\text{Total}\\ \text{Corporate}\\ \text{Income}\end{array} = \begin{array}{c}\text{Income}\\ \text{Taxable by}\\ \text{the state}\end{array}$$

So far as taxation of United States-derived income is concerned, the use of formula apportionment is both established and noncontroversial, being the preferred method of a majority of the states; a substantially smaller number of American jurisdictions — California among them — combine and apportion the *worldwide* income of multinational corporate taxpayers, a variant sometimes referred to as the "worldwide combined reporting" or "WWCR" method.[3]

Although AL/SA is the method of choice for corporate operational and internal accounting purposes, its recognized deficiencies in purporting to locate and assign taxable value to a particular jurisdiction reduce its appeal among state tax administrators, the chief proponents of competing apportionment methods. These critics cite several shortcomings in the AL/SA method: comparative distortions in measuring income, and a resulting overtaxation or undertaxation; administrative complexity generated by the need to analyze thousands of intercorporate transactions; and the common absence of uncontrolled comparable prices by which to verify the value of intercorporate "arm's length" transactions.[4]

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[3](See *Moorman Mfg. Co.* v. *Bair* (1978) 437 U.S. 267, 283, fn. 1 (Powell, J., dis.) [45 of 50 states use some form of income apportionment]; *Trinova Corp. v. Michigan Dept. of Treasury* (1991) ___ U.S. ___, ___ [111 S.Ct. 818, 831-832]; see also Chairman's Rep. and Supplemental Views, Final Rep. of the Worldwide Unitary Taxation Working Group (Aug. 1984) (hereafter Chairman's Report) p. 1 [all 45 states that levy a corporate income tax use formula apportionment to distribute taxable income of single multijurisdictional corporations]; U.S. General Accounting Office, Key Issues Affecting State Taxation of Multijurisdictional Corporate Income Need Resolving (July 1, 1982) GAO/GGD-82-38 (hereafter GAO Report), at appen. II, pp. 58-67 [tabular breakdown in use of apportionment variants among the states].)

[4]The critical literature assessing both methods is extensive. (For a sampling, see Chairman's Rep., *supra*; GAO Rep., *supra*; Note, *State Worldwide Unitary Taxation: The Foreign Parent Case* (1985) 23 Colum. J. Transnat'l L. 445; Comment, *California's Corporate Franchise Tax: Taxation of Foreign Source Income?* (1980) 20 Santa Clara L.Rev. 123; Rudy, *The California Unitary Tax Concept as Applied to the Worldwide Activities of Foreign Corporations: A Modern Commerce Clause Analysis* (1980-81) 15 U.S.F. L.Rev. 371; Note, *Multinational Corporations and Income Allocation under Section 482 of the Internal Revenue Code* (1975-1976) 89 Harv.L.Rev. 1202; Hellerstein, *State Income Taxation of Multijurisdictional Corporations: Reflections on Mobil, Exxon, and H.R. 5076* (1978) 79 Mich. L.Rev. 113; Hellerstein, *State Income Taxation of Multijurisdictional Corporations, Part II: Reflections on ASARCO and Woolworth* (1982) 81 Mich. L.Rev. 157; Hellerstein, *State Taxation Under the Commerce Clause: An Historical Perspective* (1976) 29 Vand. L.Rev. 335; Corrigan, *Interstate Corporate Income Taxation — Recent Revolutions and a Modern Response* (1976) 29 Vand. L.Rev. 423; Langbein, *The Unitary Method and the Myth of Arm's Length* (1986) 30 Tax Notes 625; see also Hearings Before the House Com. on Ways and Means on H.R. No. 5076, 96th Cong., 2d Sess. (1980).)

More fundamentally, critics of the AL/SA method have pointed to a theoretical failure of the model to account for income created by the effects of unitary interdependency. As the high court has stated in the case of a unitary business enterprise, "separate [geographical] accounting, while it purports to isolate portions of income received in various States, may fail to account for contributions to income resulting from functional integration, centralization of management, and economies of scale. [Citation.] Because these factors of profitability arise from the operation of the business as a whole, it becomes misleading to characterize the income of the business as having a single identifiable 'source.'" (*Mobil Oil Corp. v. Commissioner of Taxes* (1980) 445 U.S. 425, 438 (*Mobil Oil*).)

Of course, formula apportionment has its critics, as well. They too point to distortions in the measurement of taxable income, especially in a multinational setting where a relatively larger proportion of foreign to United States activities may result in overtaxation of the income of foreign-based unitary businesses; the substantial administrative burden of complying with income reporting requirements in United States dollars and accessing financial information that in some cases may be in the hands of literally hundreds of worldwide corporate affiliates; and the absence of uniform standards among the states for defining a unitary

business.[5] Not surprisingly, partisans on both sides of the issue contend that their method is the accepted standard — in the international arena in the case of AL/SA, and in the taxation of multijurisdictional unitary groups in the case of formula apportionment.[6]

B

The United States Supreme Court first considered the sufficiency of formula apportionment in the constitutional sense over 70 years ago, upholding Connecticut's use of a single-factor formula to apportion the income of a Connecticut business machine manufacturer whose products were marketed nationally. The high court rejected the taxpayer's due process claim that the formula taxed business conducted "beyond the boundaries of the State." As the Supreme Court explained, "[t]he profits of the [company are] largely earned by a series of transactions beginning with manufacture in Connecticut and ending with the sale in other states.... The legislature in attempting to put on this business its fair share of the burden of taxation was faced with the impossibility of allocating specifically the profits earned by the processes conducted within its borders." (*Underwood T'writer Co. v. Chamberlain* (1920) 254 U.S. 113, 120-121 (*Underwood*).)

Since *Underwood, supra,* 254 U.S. 113, the Supreme Court has confronted recurrent claims of the comparative superiority of each of these two theoretically irreconcilable techniques in responding to the distributive imperatives of the commerce clause. Despite claims of the surpassing merit of the separate accounting method, the court has refused to erect a "theoretical constitutional preference for one method of taxation over another" by mandating its use. (*Mobil Oil, supra,* 445 U.S. at p. 444.)

[5](See, e.g., Chairman's Rep., *supra*, at pp. 1-8; GAO Rep., *supra*, at pp. 32-40; and materials cited *ante*, at fn. 4.)

[6]The trial court found as a matter of fact that the AL/SA method was the "international standard of accounting" and that "[n]o other system is used internationally."

Likewise, it has rejected appeals to prescribe a variant of the formula apportionment method as a uniform national standard for interstate taxation. (*Moorman Mfg. Co. v. Bair, supra,* 437 U.S. 267, 278 (*Moorman*).)

Although the high court has refused to impose "national uniform rules for the division of income" rooted in the commerce clause (*Moorman, supra,* 437 U.S. at p. 279), it has repeatedly validated the comparative empirical accuracy and constitutional adequacy of formula apportionment. Thus, not long after upholding the due process sufficiency of formula apportionment in *Underwood, supra,* 254 U.S. 113, the court authorized its use in a multinational setting to apportion the combined income of a United Kingdom-headquartered brewer whose separate accounting showed no United States net income for the tax years at issue. Contending that the state was in effect taxing foreign income, the taxpayer asserted violations of the foreign commerce and due process clauses. (*Bass, Etc., Ltd. v. Tax Comm.* (1924) 266 U.S 271 (*Bass*).)

The high court rejected the challenge. The taxpayer's business, the court explained, was a unitary enterprise conducted transnationally, "in which its profits were earned by a series of transactions beginning with the manufacture in England and ending in sales in New York and other places — the process of manufacturing resulting in no profits until it ends in sales. . . ." The state was thus justified "in attributing to [itself] a just proportion of the profits earned by the Company from such [a] unitary business." Moreover, since the taxpayer had failed, as in *Underwood, supra,* 254 U.S. 113, to show that formula apportionment "produced an unreasonable result," its use was not unconstitutional. (*Bass, supra,* 266 U.S. at pp. 282, 283.)

In *Butler Bros., supra,* 315 U.S. 502, the taxpayer also challenged the state's use of formula apportionment on the ground that separate accounting showed its sales office in the taxing jurisdiction had no net income for the tax year at issue and that apportionment thus resulted in the taxation of extraterritorial value. The court rejected this showing as insufficient, explaining that it "need not impeach the integrity of [the separate] accounting system to say that it does not prove [taxpayer's] assertion that

extraterritorial values are being taxed. . . . A particular accounting system, though useful or necessary as a business aid, may not fit the different requirements when a State seeks to tax values created by business within its borders." (*Id.*, at p. 507.)

And in *Exxon Corp. v. Wisconsin Dept. of Revenue* (1980) 447 U.S. 207, the court rejected the attempt of a vertically integrated, multistate petroleum company to demonstrate, based on its internal use of the separate accounting method applied to distinct operating divisions, that income was allocable to extrastate components and thus constitutionally was not subject to apportionment. "[A] company's internal accounting techniques are not binding on a State for tax purposes," the court wrote. "Exxon's use of separate functional accounting . . . does not defeat the clear and sufficient nexus between [its] interstate activities and the taxing State" upon which the finding of corporate unity was based. [*Id.*, at pp. 221, 225.)

Again, in *Mobil Oil, supra*, 445 U.S. 425, a nondomiciliary corporate taxpayer challenged the state's inclusion in its apportionment formula of foreign source dividend income received by the taxpayer from subsidiaries and affiliates, on the ground that its foreign origin made it constitutionally unapportionable. Although the taxpayer was able to isolate its foreign dividend income using separate accounting, the court observed that "the linchpin of apportionability in the field of state income taxation is the unitary business principle." (*Id.*, at p. 439.) The divisibility of income produced by a separate accounting treatment, the court said, "may fail to account for contributions to income resulting from functional integration, centralization of management, and economies of scale . . . . Although separate geographical accounting may be useful for internal auditing, for purposes of state taxation it is not constitutionally required." (*Id.*, at p. 438.) (See also *ASARCO, supra*, 458 U.S. 307; *F. W. Woolworth Co. v. Taxation & Revenue Dept.* (1982) 458 U.S. 354; and *Amerada Hess Corp. v. N. J. Taxation Div.* (1989) 490 U.S. 66, 74.)

In a slightly different context, the high court recently reaffirmed its views of both the theoretical problems inherent in locating the "source" of multijurisdictional income, and the validity for commerce clause purposes of the formula apportionment method. Last term, in upholding Michigan's "value added" tax against commerce clause challenge, the court wrote that "the discrete components of a state income tax may appear in isolation susceptible of geographic designation. Nevertheless, since *Underwood* . . . we have recognized the impracticability of assuming that all income can be assigned to a single source." (*Trinova Corp. v. Michigan Dept. of Treasury, supra*, ____ U.S. ____, ____ [111 S.Ct. 818, 831].)

The court went on to reiterate its statement in *Container, supra*, 463 U.S. at page 170, that the three-factor formula "has become something of a benchmark against which other apportionment formulas are judged," noted its incorporation into UDITPA, adopted by almost half of the states, and acknowledged its accuracy in reflecting "the activities by which [taxable] value is generated." "The same factors," the court wrote, "that prevent determination of the geographic location where income is generated, factors such as functional integration, centralization of management, and economies of scale, make it impossible to determine the location of value added with exact precision." (*Trinova Corp. v. Michigan Dept. of Treasury, supra*, ____ U.S. ____ [111 S.Ct. at p. 832].)

Thus, the rule that has emerged from this series of high court encounters — spanning over 70 years — with the contending merits of two "theoretically incommensurate" systems (*Mobil Oil, supra*, 445 U.S. at p. 444) is that, for state tax purposes, neither the commerce clause nor the due process clause of the federal Constitution mandates the use of a particular methodology to allocate or distribute multijurisdictional income. Either of the two principal methods and their variants is constitutionally permissible, as long as the one chosen does not operate "unreasonably and arbitrarily" to attribute to the taxing state a percentage of total income "out of all appropriate proportion to the business transacted by the [taxpayer] in that State." (*Hans Rees' Sons v. No. Carolina* (1931) 283 U.S. 123, 135.) Or, as the high court stated in *Moorman, supra*, 437 U.S. 267, 274, "the States have wide latitude in the selection of apportionment formulas and . . . a formula-produced assessment will only be disturbed when the taxpayer has proved by clear and cogent evidence that the income

attributed to the State is in fact out of all appropriate proportion to the business transacted . . . in that State." (Internal quotation marks omitted.)

We present this extended account of the competing division-of-income methods and their treatment at the hands of the high court in order to meet at the outset the Bank's unpersuasive contention that formula apportionment is an inherently inequitable method, at least when applied to foreign-based unitary groups such as the Bank and its affiliates.[7] In substance, this argument is no different from the one explicitly rejected by the court in *Container, supra,* 463 U.S. 159. There the taxpayer presented related challenges to California's use of the three-factor formula to apportion the global income of a domestic-based unitary enterprise. Specifically, the taxpayer claimed that its foreign affiliates were significantly more profitable, and that by ignoring underlying economic realities such as lower wage and production costs among its foreign subsidiaries, three-factor formula apportionment systematically distorted the "true" allocation of income between unitary components, unfairly inflating the income apportioned to California.

"The problem with this argument," the court said, "is . . . [that] the profit figures relied on by [the taxpayer] are based on precisely the sort of formal geographical accounting whose basic theoretical weaknesses justify resort to formula apportionment in the first place." And the difficulty with the taxpayer's evidence of differing costs, the court said, "is that it does not by itself come close to impeaching the basic rationale behind the three-factor

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[7]To forestall any conceptual misunderstanding, we note that one of the two elements of the dormant foreign commerce clause analysis developed by the high court in *Japan Line, Ltd. v. County of Los Angeles* (1979) 441 U.S. 434 and subsequent cases (see *post,* p. ___ et seq. [typed maj. opn. p. 19 et seq.]) is the risk of multiple taxation posed by the challenged state taxation method. Although the high court's assessment of the principal division of income methods speaks to that risk, the foregoing summary is undertaken for the limited purpose of gauging the comparative technical or "accounting" merits of the two models, not as part of a dormant commerce clause analysis. (See *post,* p. ___ et seq. [typed maj. opn. p. 33 et seq.].)

formula. . . . [¶] Both geographical accounting and formula apportionment are imperfect proxies for an ideal which is not only difficult to achieve in practice, but also difficult to describe in theory. . . . " (*Container, supra,* 463 U.S. at p. 182.) "Of course, even the three-factor formula is necessarily imperfect," the court continued, "[b]ut we have seen no evidence demonstrating that the margin of error (systematic or not) inherent in the three-factor formula is greater than the margin of error (systematic or not) inherent in the sort of separate accounting urged upon us by [taxpayer]." (*Id.*, at pp. 183-184.)

In light of this analysis and the precedents summarized above, we conclude that, in considering the Bank's case for relief, neither of the two methods can lay claim to a decisive technical superiority or greater constitutional stature than the other.[8] We turn, then, to the merits of the Bank's contention that a dormant foreign commerce clause analysis renders unconstitutional the Board's application of the three-factor apportionment formula to the Bank's unitary enterprise.

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[8]The Bank argues that the conclusion in the *Container* opinion (*supra,* 463 U.S. at p. 184) that three-factor formula apportionment is a "proper and fair method of taxation" does not mean that its application to foreign-based multinationals produces an accurate determination of their intrastate income. The *Container* characterizations, the Bank contends, are merely the outcome of the four-part dormant interstate commerce clause analysis developed in *Complete Auto Transit, Inc. v. Brady* (1977) 430 U.S. 274. This argument strikes us as semantical at best.

The court made clear in *Trinova Corp. v. Michigan Dept. of Treasury, supra,* ___ U.S. ___ [111 S.Ct. 881, 835], that if a state tax complies with the requirement of fair apportionment, constitutional demands are exhausted. Moreover, even under a dormant foreign commerce clause analysis, both the trial court and the Court of Appeal concluded — largely under the compulsion of the identical holding in *Container, supra,* 463 U.S. 159 — that the Board's use of worldwide formula apportionment in this case did not offend the risk-of-multiple-taxation leg of the dormant analysis.

III

The Dormant Foreign Commerce Clause Doctrine

Despite the framers' explicit commitment to Congress of the power to "regulate commerce with foreign nations, and among the several states" (U.S. Const., art. I, § 8, cl. 3), by far the bulk of commerce clause jurisprudence has been developed by the high court itself under the judicially created doctrine of the "unexercised," "negative," or "dormant" commerce clause. From its origin early in the nation's constitutional history with the opinion of Chief Justice Marshall in *Gibbons v. Ogden* (1824) 22 U.S. (9 Wheat.) 1, 209, through its reformulation at the hands of Justice Curtis in *Cooley v. Board of Wardens of Port of Philadelphia et al.* (1852) 53 U.S. (12 How.) 298, the high court has posited irreducible and self-executing constitutional minima that limit state action affecting interstate and foreign commerce, even where Congress has *failed* to exert its plenary commerce clause power. "[T]he Commerce Clause was not merely an authorization to Congress to enact laws for the protection and encouragement of commerce among the States, but by its own force created an area of trade free from interference by the States. In short, the Commerce Clause even without implementing legislation by Congress is a limitation upon the power of the States. . . ." (*Freeman v. Hewit* (1946) 329 U.S. 249, 252; see also *Southern Pacific Co. v. Arizona* (1945) 325 U.S. 761, 769 ["For a hundred years it has been accepted constitutional doctrine that the commerce clause, without the aid of Congressional legislation . . . affords some protection from state legislation inimical to the national commerce, and that in such cases, where Congress has not acted, this Court, and not the state legislature, is under the commerce clause the final arbiter of the competing demands of state and national interests. [Citations.]"]; *Hood & Sons v. Du Mond* (1949) 336 U.S. 525, 534; *Northwestern Cement Co. v. Minn.* (1959) 358 U.S. 450, 458; *Hughes v. Oklahoma* (1979) 441 U.S. 322, 326, fns. 2 & 3; *Wyoming v. Oklahoma* (Jan. 22, 1992) ____ S.Ct. ____, ____ [60 U.S.L. Week 4119, 4124].)

In the modern era, the consolidative work of the court led it to recast the interstate dimension of the dormant commerce clause doctrine as it applies to state taxation. In *Complete Auto Transit, Inc. v. Brady, supra*, 430 U.S. 274, the court adopted a four-part test to evaluate state tax schemes to ensure compliance with the inherent demands of the "unexercised" commerce clause. If a tax "is applied to an activity with a substantial nexus with the taxing State, is fairly apportioned, does not discriminate against interstate commerce, and is fairly related to the services provided by the State," it does not burden impermissibly interstate commerce. (*Id.*, at p. 279.)

This four-part test is not adequate, however, to subserve the additional policies underlying the foreign commerce clause. In *Japan Line, Ltd. v. County of Los Angeles, supra*, 441 U.S. 434 (*Japan Line*), the court held that "[w]hen construing Congress' power to 'regulate Commerce with foreign Nations,' a more extensive constitutional inquiry is required." (*Id.*, at p. 446.) Specifically, "two additional considerations, beyond those articulated in *Complete Auto*, come into play." (*Ibid.*) "In addition to answering the nexus, apportionment, and nondiscrimination questions posed in *Complete Auto*, a court must also inquire, first, whether the tax, notwithstanding apportionment, creates a substantial risk of international *multiple taxation*, and second, whether the tax prevents the Federal Government from 'speaking with *one voice* when regulating commercial relations with foreign governments.' If a state tax contravenes either of these precepts, it is unconstitutional under the [foreign] Commerce Clause." (*Id.*, at p. 451, emphasis added.)

Although the court's opinion in *Japan Line, supra*, 441 U.S. 434, stressed the paramount national need for and plenary nature of congressional power over foreign commerce — greater, perhaps, than Congress's textually parallel power over interstate commerce (*id.*, at p. 448 & fns. 12-13) — as one of the fundamental policies animating the framers, it had little to say concerning the preemptive role of Congress in defining the contours of permissible state taxation of foreign commerce. The court illuminated that question a year later when it decided *Mobil Oil, supra*, 445 U.S. 425, a challenge by Mobil to Vermont's tax on foreign dividend income. Rejecting what it termed Mobil's "forced" analogy to California's tax on Japanese shipping containers at issue in *Japan Line*, the court said that the real issue before it was

not one of multiple taxation at the international level, as in *Japan Line*, but of multiple taxation at the state level.

"Concurrent federal and state taxation of income, of course, is a well-established norm," the court wrote. "Absent some *explicit directive from Congress*, we cannot infer that treatment of foreign income at the federal level mandates identical treatment by the States. The absence of any *explicit directive* to that effect is attested by the fact that Congress has long debated, but has not enacted, legislation designed to regulate state taxation of income. [Citations.]" (*Mobil Oil, supra*, 445 U.S. at p. 448, emphasis added.)

The view taken in *Mobil Oil, supra*, 445 U.S. 425, that Congress, under its " 'exclusive and absolute' power . . . over foreign commerce" (*Japan Line, supra*, 441 U.S. at p. 448, fn. 13, quoting *Buttfield v. Stranahan* (1904) 192 U.S. 470, 492), is the source of "explicit directive[s]" *preempting* state taxation of foreign commerce, was amplified in the court's treatment of the issue in *Container, supra*, 463 U.S. 159. The court first noted that "allocating income among various jurisdictions bears some resemblance . . . to slicing a shadow," and concluded that "it would be perverse, simply for the sake of avoiding double taxation, to require California to give up one allocation method that sometimes results in double taxation [i.e., formula apportionment] in favor of another allocation method [i.e., AL/SA] that also sometimes results in double taxation." (*Id.*, at pp. 192-193.) It then turned to the "second inquiry suggested by *Japan Line*," namely, whether California's use of formula apportionment in an international context might " 'impair federal uniformity in an area where federal uniformity is essential,' " and " 'prevent the Federal Government from "speaking with one voice" in international trade.' " (*Ibid.*)

In examining the "one voice" branch of the dormant commerce clause doctrine, the court in *Container* was careful to distinguish between state tax schemes that are unconstitutional because they implicate foreign affairs and those that, although they may have "foreign resonances," are void because they "violate[] a clear federal directive." While either infirmity will offend the "one voice" standard, the latter does so, the court said, not as a result

of a dormant commerce clause analysis, but because of "some *explicit directive from Congress*." This latter analysis, the court noted, "is, of course, essentially a species of pre-emption . . . ." (*Container, supra*, 463 U.S. at p. 194, emphasis added.)

Applying the "explicit directive from Congress" language of *Mobil Oil, supra*, 445 U.S. 425, and canvassing "specific indications of congressional intent," the *Container* opinion found neither statutory preemption by Congress nor any requirement that the AL/SA method be applied to the states in any of the many bilateral tax treaties to which the United States was a signatory. Indeed, the court pointed out, "the Senate has on at least one occasion, in considering a proposed treaty, attached a reservation declining to give its consent to a provision in the treaty that would have extended [an AL/SA] restriction to the States." (*Container, supra*, 463 U.S. at pp. 196-197.) "[I]t remains true," the court concluded, "as we said in *Mobil*, that 'Congress has long debated, but has not enacted, legislation designed to regulate state taxation of income.' " (*Ibid.*)

Although the court concluded in *Container* that the Board's use of formula apportionment did not violate the foreign commerce clause under a dormant analysis, it is important for our purposes to observe that the opinion carefully separates the analytical thread of congressional *preemption* from what the court termed a "more relaxed standard which takes into account our residual concern about the foreign policy implications of California's tax." (*Container, supra*, 463 U.S. at p. 197.) In the former case, there obviously is no need for resort to a dormant analysis since Congress has *explicitly* exerted its plenary authority under the commerce power to *preempt* a state tax scheme that, far from "implicating foreign affairs," has only "foreign resonances."[9] As

[9]Compare the court's statement in *Merrion v. Jicarilla Apache Tribe* (1982) 455 U.S. 130, 154-155, that "we only engage in [dormant analysis] review when Congress has not acted or purported to act. [Citation.] Once Congress acts, courts are not free to review state taxes or other regulations under the dormant Commerce Clause. When Congress has struck the balance it deems appropriate, the courts are no longer needed to prevent States from burdening commerce, and it

the *Container* opinion makes clear, however, the court will not lightly overturn the historic prerogatives of the states to administer their own tax systems. Before being declared nullified by Congress under this "species of pre-emption," the "federal directive" that a state tax scheme allegedly violates must be "clear." (463 U.S. at p. 194.)

The "more relaxed standard" of a dormant analysis — based on "residual concern[s]" about the "foreign policy implications" of a given state tax scheme — is appropriate only "in the absence of explicit action by Congress" preempting a given state taxation method. It is undertaken by a judiciary with "little competence in determining precisely when foreign nations will be offended by particular acts, and even less competence in deciding how to balance a particular risk of retaliation against the sovereign right of the United States as a whole to let the States tax as they please." (*Container, supra*, 463 U.S. at p. 194.) Thus, it is for reasons of its limited foreign policy expertise that, in conducting a dormant "one voice" inquiry, the "best that [a court] can do, in the absence of explicit action by Congress [preempting a challenged state tax scheme], is to attempt to develop objective standards that reflect very general observations about the imperatives of international trade and international relations." (*Ibid.*) Where they apply, the development of such standards is informed significantly by the views of executive officials charged with implementing the nation's foreign policy — including its foreign commercial policy — "whose nuances ... are much more the province of the Executive Branch and Congress than of this Court." (*Id.*, at p. 196.)

As might be expected, the Bank argues at length that the Board's application of formula apportionment to the unitary business of which it is a part offends the foreign commerce clause precisely because it violates a "clear federal directive." That directive, the Bank tells us, is embodied in an impressive array of federal executive communications — presidential statements and

matters not that the courts would invalidate the state tax or regulation under the Commerce Clause in the absence of congressional action. [Citation.] Courts are final arbiters under the Commerce Clause only when Congress has not acted."

press releases; official letters from cabinet officers charged with overseeing national monetary, trade, and foreign policies; the testimony of senior Treasury Department officials; and the "white paper" of an executive task force established to study and present recommendations on the issues surrounding state use of formula apportionment to foreign-based unitary groups. Without exception, the Bank argues, these executive sources vigorously and explicitly support the exclusive use of the AL/SA method in such circumstances and condemn the use of formula apportionment by the states.

The Court of Appeal essentially agreed with the Bank's underlying premise that *executive* pronouncements of what national foreign commercial policy *should* be qualifies as a source of the "clear federal directive." It reasoned that because the *Container* opinion (*supra*, 463 U.S. 159) subsumed the search for specific indications of congressional intent within the "one voice" standard, congressional intent must therefore be an integral component of the dormant commerce clause test. From that analytical keystone, it had little difficultly in concluding on the basis of a substantial executive-compiled record that the federal directive was clear and explicit: according to executive branch officials, formula apportionment, in the words of the Court of Appeal, "is not to be applied to foreign-based corporate groups — those groups are to be taxed by the states only on income derived from the United States."

Were we confronted with the Bank's argument in the immediate aftermath of the *Container* decision, it might carry some force, although given the absence of textual support for the claim — both in the *Container* opinion and the commerce clause itself — it is by no means facially convincing. The fact is, however, that dormant foreign commerce clause jurisprudence has evolved in the nine years since *Container, supra*, 463 U.S. 159, was decided, an evolution that, as we parse the cases, has reoriented the doctrine. That development has reduced the scope for a dormant analysis and makes its invocation here particularly inappropriate.

IV

Wardair: A "Governmental Silence" of a Different Kind.

Three years after its opinion in *Container, supra,* 463 U.S. 159, upholding California's use of formula apportionment in calculating the intrastate tax liability of a domestic-based unitary business, the high court decided ***Wardair Canada v. Florida Dept. of Revenue*** (1986) 477 U.S. 1 (***Wardair***). At issue was a Canadian-based international air carrier's challenge to an excise tax assessed by Florida on intrastate fuel purchases by common carriers, including airlines. The tax was levied at the rate of 5 percent on a deemed fuel price of $1.148 per gallon; air carriers were liable for the full amount of the tax whether the fuel was consumed in flights within or outside the state, regardless of the amount of intrastate business transacted by the taxpayer. (*Id.,* at p. 4.)

In attacking application of the tax to its Florida fuel purchases on foreign commerce clause grounds, the carrier — joined by the United States as amicus curiae — conceded that the tax, being assessed on discrete intrastate transactions, presented no risk of multiple international taxation. It relied instead entirely on the "one voice" element of the dormant foreign commerce clause analysis, the last of the six factors identified by the court in *Japan Line, supra,* 441 U.S. 434.

Specifically, the carrier contended that a patchwork of reciprocal tax exemptions, embodied in a network of multilateral agreements and conventions to which the United States was a party, manifested a national policy to exempt from state taxation the instrumentalities of international air commerce, including aviation gasoline. Florida's excise on aviation fuel purchased by a foreign carrier engaged in international air commerce, the carrier claimed, was inconsistent with that univocal national policy, thus threatening "the ability of the Federal Government to 'speak with one voice.'" (***Wardair, supra,*** 477 U.S. at p. 9.)

The high court rejected the claim. Not only did the matrix of international conventions, resolutions and air commerce agreements relied on by the carrier and the United States fail to sustain a federal policy pretermiting Florida's excise on aviation fuel, the high court said, "but, even more fundamentally, [it] shows also that in the context of this case we do not confront federal governmental silence of the sort that triggers dormant Commerce Clause analysis." In point of fact, the court continued, "the international agreements cited demonstrate that the Federal Government has affirmatively acted, rather than remained silent, with respect to the power of the States to tax aviation fuel, and thus that the case does not call for dormant Commerce Clause analysis at all." (***Wardair, supra,*** 477 U.S. at p. 9.)

As we explain below, the court's opinion in ***Wardair, supra,*** 477 U.S. 1, establishes an interpretive framework for educing from a compilation of legislative materials a species of governmental *silence* that forecloses resort to a dormant foreign commerce clause analysis. In some cases where Congress affirmatively declines to adopt certain measures, the resulting governmental "silence" is not the sort that triggers use of a dormant foreign commerce clause analysis. Properly applied under the appropriate conditions, the ***Wardair*** methodology interdicts judicial resort to executive branch opinions as to the international commercial effect of a challenged state taxation practice because Congress has "acquiesced in" the contested practice, thereby validating it. (*Id.,* at p. 12.) Where appropriate, ***Wardair*** supplants what the court has termed the "quagmire" of dormant commerce clause analysis (*Northwestern Cement Co. v. Minn., supra,* 358 U.S. 450, 458) with a heightened judicial attentiveness to expressions of congressional foreign commerce policy. Because it delimits use of dormant foreign commerce clause analysis in important ways, it is useful to lay out the analytical lines of the ***Wardair*** paradigm in some detail before applying it to the case before us.

The foreign carrier in ***Wardair, supra,*** 477 U.S. 1, relied on a hierarchy of multinational agreements to support its thesis that federal policy precluded state taxation of intrastate aviation fuel purchases by international carriers: the Chicago Convention on International Civil Aviation (Convention), signed in 1944 by the United States, Canada, and 155 other nations; a resolution adopted in 1966 by the International Civil Aviation Organization, of which the United States was a member by virtue of being a signatory to the Convention; and more than 70 bilateral international aviation agreements between the United States and foreign

nations, including a United States-Canadian aviation agreement. (*Wardair, supra*, at p. 10.) But it was these very texts, the high court concluded, that in combination impeached the existence of a national policy to exempt international air commerce from state taxation and, by their "negative implications," supported an inference that "the United States has at least acquiesced in state taxation of fuel used by foreign carriers in international travel." (*Id.*, at p. 12.)

First, a provision of the Convention explicitly prohibited taxation by both national and subnational governmental units of fuel "on board" arriving international aircraft. The Convention failed, however, to reach the issue of taxing intrastate fuel *purchases* by foreign aircraft following their arrival. This omission, the court reasoned, demonstrated by "negative implication" the "international community's awareness of the problem of state and local taxation of international air travel . . . and represent[ed] a decision by the parties to [the] Convention to address the problem by curtailing . . . only some of the localities' power to tax, while implicitly preserving other aspects of that authority." (*Wardair, supra*, 477 U.S. at p. 10.)

Second, the resolution relied on by the carrier, although endorsing an international regime prohibiting duties of any kind by any taxing authority on international air travel, had "not been specifically endorsed, let alone signed, entered into, agreed upon, approved, or passed by either the Executive or Legislative Branch of the Federal Government. In other words, no action has been taken to give the Resolution the force of law." (*Wardair, supra*, 477 U.S. at p. 11.) It thus could not tenably represent, the court concluded, "a policy *of the United States*, as opposed to a policy of an organization of which the United States is one of many members." (*Ibid.*, emphasis in original.)

Third, in the years following the Convention, the United States entered into more than 70 bilateral international civil aviation agreements, "in not one of [which] has the United States agreed to deny the States the power asserted by Florida in this case." Significantly, most of these agreements "explicitly commit the United States to refrain from imposing *national* taxes on aviation fuel used by airlines of the other contracting party . . . but . . .

none . . . explicitly interdicts state or local taxes on aviation fuel used by foreign airlines in international traffic." (*Wardair, supra*, 477 U.S. at p. 11, emphasis in original internal quotation marks omitted.) Reenforcing this view, the United States-Canadian agreement also limited tax exemptions granted foreign air carriers to "national duties and charges," an "omission [to reach subnational duties] which must be understood as representing a policy choice by the contracting parties. . . . " (*Ibid.*)

Summing up the implications of this mosaic of texts for a dormant commerce clause attack on Florida's tax, the court concluded that "[w]hat all of this makes abundantly clear is that the Federal Government has not remained silent with regard to the question whether States should have the power to impose taxes on aviation fuel used by foreign carriers in international travel." (*Wardair, supra*, 477 U.S. at p. 12.) "It would turn dormant commerce Clause analysis entirely upside down," the court continued, "to apply it where the Federal Government has acted, and to apply it in such a way as to *reverse* the policy that the Federal Government has elected to follow. For the dormant Commerce Clause, in both its interstate and foreign incarnations, only operates where the Federal Government has *not spoken. . . .* " (*Ibid.*, first emphasis in original, second emphasis added.)

For our purposes, the high court's analysis of the textual materials in *Wardair, supra*, 477 U.S. 1, can be abstracted into a kind of protocol for identifying those kinds of governmental silences that give rise to "negative implications" supporting an inference of federal acquiescence in the state tax under challenge. Thus, in *Wardair* the court found that bilateral recognition of an international taxation issue and its specific treatment at the national level (numerous international aviation agreements exempting foreign air carriers from national duties), impliedly supported a finding that the failure to address the correlative issue at the subnational level represented "a policy choice by the contracting parties." (*Id.*, at p. 11.)

By a kind of parity of reasoning, *Wardair* found that the explicit treatment of *some* subnational aspects of an international taxation issue (Convention prohibition on state taxation of fuel aboard

arriving foreign aircraft) supported an inference of international "awareness of the problem" at the state level and a "decision . . . to address the problem by [limited curtailment of the subnational power] . . . while implicitly preserving other aspects of [subnational] authority." (477 U.S. at p. 10.) Last, the court found that notwithstanding an international aspiration to erect a particular tax regime (the resolution's endorsement of the complete eradication of national and subnational duties on international air travel), the fact that domestic "*law* as it presently stands acquiesces in taxation . . . by political subdivisions" was decisive of the commerce clause issue. (*Ibid.*, emphasis in original.)

Before considering the history of congressional consideration of curbs on the states' application of formula apportionment to foreign-based multinationals in light of the court's analysis in *Wardair*, we first consider the treatment of *Wardair* at the hands of the Court of Appeal.

V

The Wardair Canon and Congressional Refusal to Prohibit State Use of Formula Apportionment

A

As noted *ante*, the Court of Appeal declined to accept the view that *Wardair, supra*, 477 U.S. 1, represents, if not a change of course in the high court's dormant foreign commerce clause jurisprudence, at least a retrenchment in its scope. It also concluded that statements of executive branch officials as to United States foreign commercial policy could constitute the "clear federal directive" component to the "one voice" analysis of *Japan Line, supra*, 441 U.S. 434, *Mobil Oil, supra*, 445 U.S. 425, and *Container, supra*, 463 U.S. 159.

In our view, both of these conclusions are born of the root error of failing to grasp the conceptual impact of *Wardair, supra*, 477 U.S. 1, on dormant foreign commerce clause doctrine. As we explain, the failure of the Court of Appeal to appreciate *Wardair's* limitations on dormant commerce clause analysis is cognate to its erroneous view that executive branch aspirations as

to what national foreign commercial policy ought to be can constitute a "clear federal directive," at least where, under a *Wardair* analysis, Congress has decreed otherwise.

The Court of Appeal rejected the Board's argument that *Japan Line, Container*, and *Wardair* demonstrate a trend in foreign commerce clause jurisprudence toward a heightened attention to governmental expressions of United States foreign commercial policy. Instead, it concluded that "the theoretical underpinning has remained intact through these cases." What was different in them, it thought, "was the degree to which foreign affairs and international commercial relations where implicated" by the challenged state tax scheme.

It may be that the application of such a theme to these three cases would produce a coherent alternative explanation of the results reached by the high court. To contend, however, that *Wardair, supra*, 477 U.S. 1, turns on "the degree of which foreign affairs and international commercial relations were implicated," is to misread fundamentally the court's opinion. Such a view ignores the high court's explicit statement that in *Wardair* it "[did] not confront federal governmental silence of the sort that triggers dormant Commerce Clause analysis," that the case "does not call for dormant Commerce Clause analysis at all," and that "[i]t would turn dormant Commerce Clause analysis entirely upside down to apply it where the Federal Government has acted." (*Id.*, at pp. 9, 12.) We are confident that the overarching significance of *Wardair* lies in its explicit limitation on when a dormant foreign commerce clause analysis is appropriate, its affirmation that the analysis "only operates where the Federal Government has not spoken," and its statement that the court "[has] never suggested . . . that the Foreign Commerce Clause *insists* that the Federal Government speak with any particular voice." (*Id.*, at pp. 12, 13, emphasis in original.)

The Court of Appeal's misapprehension of this central meaning of *Wardair*, supra, 477 U.S. 1, led it to a related error — the conclusion, against the backdrop of an explicit *congressional* refusal to adopt curbs on state use of formula apportionment, that a trial of letters, press releases, task force reports, transcripts of congressional testimony of Treasury Department officials, and like

communications orchestrated by the executive branch could constitute a "clear federal directive" condemning state use of formula apportionment in foreign parent cases. As we have indicated, however, the "clear federal directive" formulation in *Container, supra*, 463 U.S. 159, has no role to play in a dormant foreign commerce clause analysis; rather, it confirms the preemptive power of *Congress* to interdict state tax schemes that would, had Congress *not* chosen to act, survive challenge under a dormant foreign commerce clause analysis because they present only "foreign resonances." (*Id.*, at p. 194.)

Whether, in the absence of a congressionally enacted "clear federal directive," the executive branch can itself assume a preemptive role and in effect nullify state tax schemes as they affect foreign-based businesses is a distinctly different question. The Court of Appeal, relying principally on the concurring opinion of Justice Jackson in *Youngstown Co. v. Sawyer* (1952) 343 U.S. 579, 634 — the famous "steel seizure case" — concluded that such a power inhered in the President's authority to conduct foreign affairs and that the executive had spoken with sufficient clarity to prohibit state application of formula apportionment to foreign parent unitary groups such as the Bank.

In light of *Wardair, supra*, 447 U.S. 1, we need not and do not reach this issue. For in the debate over state use of worldwide formula apportionment — a controversy waged on multiple fronts by foreign governments, multinationals and their domestic and foreign affiliates, state tax authorities, senior Treasury and State Department officials, the White House and Congress — we hear the din of a "governmental silence" that cannot be ignored. In our view, Congress, after being repeatedly pushed and pulled in both directions, at least for the present has decided *not* to prohibit state use of formula apportionment in cases of this kind. To paraphrase the *Wardair* opinion, international agreements demonstrate that the federal governmental has affirmatively acted, rather than remained silent, with respect to the power of the states to employ formula apportionment in so-called foreign parent cases; as a result, this case does not call for dormant foreign commerce clause analysis at all. (477 U.S. at p. 9.)

As we explain in some detail below, over the past 25 years, senior tax and foreign policy officials of the executive branch have sought to respond to the demands of foreign governments that the states be barred from applying formula apportionment to determine the tax liability of foreign-based multinationals. For much of this period, the chief forum for resulting executive branch initiatives was the Senate, where successive administrations sought to win ratification of a treaty provision barring state use of formula apportionment. But in 1978, with explicit recognition of the "negative implications" of its act, the Senate *rejected* an income tax convention negotiated by the executive branch with the United Kingdom whose centerpiece was a provision — article 9(4) — prohibiting the states from using formula apportionment in determining the intrastate tax liability of United Kingdom-based multinationals. Only after the ban on state use of formula apportionment was stricken was the administration able to muster the two-thirds majority required for Senate ratification under the treaty clause.

In addition, numerous bilateral tax treaties between the United States and other nations, although precluding use of formula apportionment by the signatory *national* governments, do not include within that prohibition political subdivisions such as the states. And while such tax treaties *do* include subnational governments within the scope of nondiscrimination provisions, they are *not* included within the prescription that the signatory governments employ an AL/SA methodology in taxing local branches of foreign corporations. Similarly, so-called "Friendship, Commerce and Navigation" treaties — a common form of commercial agreement between the United States and its trading partners — typically require both the federal and state governments to tax foreign enterprises within their jurisdictions on a "reasonably allocable or apportionable" basis, a standard which United States drafters viewed as "intended to cover all the various methods, proportionate or otherwise, by which a reasonable tax base might be determined." (U.S. State Dept., Standard Draft Treaty of Friendship, Commerce and Navigation, prepared by Charles H. Sullivan (Aug. 1980) pp. 202, 203.)

Finally, in the wake of Senate rejection of article 9(4) and the decision in *Container, supra*, 463 U.S. 159, upholding California's use of worldwide unitary methods in taxing domestic-parent multinationals, the executive branch scuttled its effort to achieve treaty-imposed curbs on the states' use of worldwide formula apportionment. Instead, the administration proceeded on other fronts, first seeking the voluntary cooperation of the states in mitigating the internationally effects of formula apportionment and, in a new tack, presenting its views in selected litigation through amicus curiae participation, before again renewing its call for Congress to enact restrictive legislation.

It is in the course of this undertaking that the executive branch has produced what the Bank insists is the "clear federal directive" that sustains its dormant foreign commerce clause case. We think, however, that rather than qualifying as a "clear federal directive," these materials, in the context of Congress's persistent refusal to regulate state taxation of multinationals and the Senate's explicit rejection of article 9(4) of the United States-United Kingdom treaty, embody nothing more than executive aspirations of what the federal government's policy in this area *ought* to be.

B

In 1975, the Ford administration concluded a bilateral income tax convention with the United Kingdom, a central feature of which was the following provision, article 9(4):

"Except as specifically provided in this Article, in determining the tax liability of an enterprise doing business in a Contracting State, or in a political subdivision or local authority of a Contracting State, such Contracting State, political subdivision or local authority shall not take into account the income, deductions, receipts, or outgoings of a related enterprise of the other Contracting State or of an enterprise of any third State related to an enterprise of the other Contracting State."[10]

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[10](Convention Between United States and United Kingdom for Avoidance of Double Taxation, Dec. 31, 1975, 31 U.S.T. 5670, 5677, T.I.A.S. 9682.)

When the succeeding Carter administration sought Senate ratification of the convention, state tax authorities attacked article 9(4) as an infringement on state powers of taxation, reached by executive branch negotiators without prior consultation with the states. They vigorously lobbied for its excision. Following a series of committee and floor votes, the Senate ultimately ratified the treaty, subject to the telling reservation "that the provisions of paragraph (4) of Article 9 . . . shall not apply to any political subdivision or local authority of the United States." (124 Cong. Rec. 18416 (1978).)

Explaining one of the motivations behind the reservation, which in effect struck article 9(4) from the treaty, its chief proponent objected to executive branch use of "the device of a tax treaty" to "impose major changes in internal tax policy" by circumventing congressional consideration of the states' use of formula apportionment. (Remarks of Sen. Church, 124 Cong. Rec. 18416 (1978).) "For some 10 years," the sponsor of the reservation stated, "Congress has been rejecting the type of limitation on the power of our State governments to tax which is incorporated in article 9(4) of the pending treaty." (*Ibid.*) Immediately following ratification of the United States-United Kingdom tax convention as amended by the so-called "Church reservation," Senator Javits, a chief sponsor of the treaty, including article 9(4), noted that "what we [the Senate] have done is very serious . . . We have for all practical purposes eliminated a very important provision of this treaty [article 9(4)] for which the United Kingdom believed it had entered into the treaty." (Remarks of Sen. Javits, 124 Cong. Rec. 19077 (1978).)

The parallels between this evidence of "governmental silence" or refusal to act and that regarded as decisive in *Wardair, supra*, 477 U.S. 1, seem to us both evident and compelling. As in *Wardair*, an international agreement (here the bilateral income tax treaty between the United States and the United Kingdom) demonstrates that while federal executive branch officials *aspired* to eliminate a state tax practice (here the use of formula apportionment to calculate the tax liability of foreign-based multinationals), "the *law* as it presently stands acquiesces" in the states' continued use of that practice. As in *Wardair*, "the negative

implications" of international agreements (here the tax treaty as ratified by the Senate) support recognition of a federal policy that *acquiesces* in the states' tax practice. And certainly, in the circumstances of Senate consideration detailed above, the explicit removal of "political subdivisions" from the scope of article 9(4) effected by the Church reservation, like the omission of restrictions on taxation by political subdivisions in the international agreements considered in *Wardair*, "must be understood as representing a policy choice by the contracting parties." (*Wardair, supra*, 477 U.S. at p. 11.)[11]

The Court of Appeal rejected the analogy to *Wardair, supra*, 477 U.S. 1, on the ground that, in both a committee vote and on the Senate floor, the Church reservation failed to command a plurality, and the vote for the treaty *with* article 9(4) was only five votes short of the needed two-thirds majority. In light of these tallies, it reasoned that it was difficult to see a congressional policy permitting the states to use formula apportionment. In our view, however, the focus on preliminary votes misses the mark.

Preliminary voting tallies lack meaning precisely because they are not definitive, may be cast for any number of tactical parliamentary reasons, and thus do not reliably reflect legislative policy. The sole constitutional mechanism for congressional consideration of executive-negotiated treaties is Senate ratification by a two-thirds majority (U.S. Const., art. II, § 2); to that defining vote, institutional significance sensibly can and should be ascribed. In any case, the method enjoined upon us by *Wardair, supra*, 477 U.S. 1, requires that we ponder the significance of "the *law* as it stands," not count noses.

The Senate's action with respect to article 9(4) is only the most explicit example of a persistent congressional refusal to enact curbs on the states' use of worldwide formula apportionment reaching back well before 1977, the tax year at issue in this case. The parties agreed in a pretrial stipulation that "various proposed Legislative bills have been introduced in the United

[11]Parliament eventually acceded to Congress's demands, ratifying the income tax convention without article 9(4). (See 31 U.S.T., *supra*, 5709-5710.)

States Congress that would, among other things, affect the states' use of worldwide combined reporting." The stipulation identifies twenty such House and Senate bills spanning twenty years. These range from House Resolution No. 11798 introduced in the House in 1965 (an ambitious "Interstate Taxation Act" that would have required the states to adopt a two-factor apportionment formula in taxing unitary groups) to 1985 legislation sponsored by the Treasury Department that would have limited state use of worldwide formula apportionment to members of foreign-based corporate groups actually doing business in the United States, that is, so-called "water's edge" legislation. (See *post*, p. ___ [typed maj. opn. pp. 52-54].) None of these measures was enacted into law by Congress.

We likewise part company with the Court of Appeal in its view of the significance to be drawn from the web of bilateral tax conventions into which the United States has entered both before and after the Senate's rejection of article 9(4). As noted, these conventions typically require use of the separate accounting method by the national signatory governments in their tax treatment of domestic branches of foreign-based businesses.[12] This restriction, however, does not encompass division of income methods used by political subdivisions of the contracting states.

Again, the Court of Appeal found the analogy to *Wardair, supra*, 477 U.S. 1, inapt because, unlike that case — in which subsequent air commerce agreements rested on the foundational understanding of the Convention — many of the agreements relied on by the Board in this case predate an international awareness of formula apportionment issues that did not arise until the 1970's. Thus, according to the Court of Appeal, affirmative

[12]Representative treaty language appears, for example, in article VII, section 2 of the United States-Canadian treaty of 1984, providing for tax treatment of domestic branches of foreign-domiciled corporations as "if it were a distinct and separate person engaged in the same or similar activities under the same or similar conditions and dealing wholly independently" with the rest of the corporation. (Convention Between United States and Canada with Respect to Taxes on Income and Capital, Aug. 16, 1984.)

prescriptions of national division of income methods in international treaties would not support *Wardair's* "negative implications" that the parties were aware of competing methods and made the conscious decision to acquiesce in their use by the states.

Despite the facial plausibility of this reasoning, we cannot accept the supposition underlying it that formula apportionment as a division of income alternative to separate accounting for taxation purposes did not penetrate the international financial and diplomatic consciousness until the multinational corporate boom of the 1970's. The high court's 1924 decision in *Bass, supra*, 266 U.S. 271, upholding the constitutionality of state use of formula apportionment to a United Kingdom-based taxpayer, suggests at a minimum notice to the international business community of the valid use of an alternative to separate accounting by political subdivisions of the United States.

Although the Court of Appeal also rejected this argument on the ground that "awareness of a particular tax theory is one thing; to be subjected to that theory in practice is quite another," we think that this reasoning requires greater proof than that demanded by *Wardair, supra*, 477 U.S. 1. The dramatic growth of multinationals during the 1960's and 1970's may well have served to sharpen corporate concern over the international effects of the states' use of formula apportionment, but that increased apprehension does not demonstrate a prior lack of awareness of its potential applicability or negate the sensible decision of United States treaty negotiators — operating with an awareness of a federalist-based tax practice — to include a standard provision limiting only national governments to the AL/SA method.[13]

[13]Thus, one of the leading spokesmen of executive branch opposition to state use of the worldwide unitary method, Donald Lubick, Assistant Secretary of the Treasury for Tax Policy, explained why, except for the nondiscrimination clause, subnational taxes were not included in the United States Model Income Tax Treaty by noting that "local U.S. taxes are not covered because it is unlikely that the United States would consent to the ratification of any treaty provision that restricted the rights of the . . . states to impose their own taxes." (See International

There is evidence suggesting a basis for just such an international recognition of formula apportionment as a competing taxation method, at least from the mid-1950's on. The *Container* case itself dealt with California's use of formula apportionment for the 1963 to 1965 tax years (463 U.S. at p. 171) and a prior decision of our Court of Appeal (*Anaconda Co. v. Franchise Tax Board* (1982) 130 Cal.App.3d 15) dealt with the tax years 1955 through 1969.[14] Moreover, in enacting the Internal Revenue Act of 1956, Congress authorized the Secretary of the Treasury to "distribute, *apportion*, or allocate gross income . . . between or among" multicorporate enterprises, including those with foreign domiciles, "in order . . . clearly to reflect [their] income" (26 U.S.C. § 482, emphasis added), a formulation that reflects at least an awareness of apportionment methodologies.[15] Similarly, as early as the late 1940's, United States negotiators of "Freedom, Commerce and Navigation" agreements incorporated standards to preserve the states' freedom to employ methods that produced a tax "reasonably allocable or apportionable" to the taxing jurisdiction, a formulation American drafters described as limiting state levies to "a fair portion of a global income derived from dual or multiple territorial sources." (U.S. State Dept., Anno. Draft

Tax Treaties: Hearing Before the Sen. Com. on Foreign Relations, 96th Cong., 1st. Sess., at p. 112.)

The United States (together with two other federalist nations, Canada and Australia) likewise reserved its position "on that part of paragraph 1 [of article 1 of the Organization for Economic Co-operation and Development [OECD] Model Taxation Convention] which states that the Convention [which requires use of a separate accounting method] should apply to taxes of political subdivisions or local authorities." (Model Double Taxation Convention on Income and on Capital (1977), at p. 50.)

[14]A key 1984 Treasury Department document notes that debate on state use of the worldwide version of formula apportionment "spans *at least two decades*." (Chairman's Rep., *supra*, at p. 3, emphasis added.)

[15]The 1954 version, as well as the current version of 26 United States Code section 482, derives from section 45 of the Revenue Act of 1928. (See H.R. Rep. No. 2, 70th Cong., 1st Sess., p. 16 (1928).)

Treaty of Friendship, Commerce and Navigation for Portugal, prepared by Herman Walker (1947-1948) pp. 14a, 15.)

In addition, bilateral income tax treaties negotiated by the United States with many of its trading partners typically prescribe use of the AL/SA method by the signatory governments; they do not, however, impose such a requirement on taxation by subnational levels of government. Moreover, despite this methodological exemption, subnational organs of government *are* included for purposes of nondiscrimination treaty provisions. We think this latter evidence substantially parallels the *Wardair* paradigm, where the high court concluded that the "negative implications" arising from the Convention's limited ban on state taxation of fuel "on board" arriving foreign aircraft demonstrated an awareness of subnational taxation issues and represented "a decision by the parties . . . to address the problem by curtailing and limiting only some of the localities' power to tax, while implicitly preserving other aspects of that authority." (*Wardair, supra*, 477 U.S. at p. 10.) In short, an extensive pattern of executive branch-negotiated diplomatic texts parallels, in our view, Congress's own unwillingness to disallow legislatively the states' application of formula apportionment methods to foreign-controlled multinational taxpayers, and bespeaks a coordinate "acquiescence."

Finally, the strategy pursued by the executive branch in the wake of the high court's opinion in *Container, supra*, 463 U.S. 159, underlines the aspirational character of its insistence on an end to state use of formula apportionment in foreign-parent cases. Although in the immediate aftermath of the decision, the administration rejected appeals by the business community and major trading partners to seek amicus curiae status in *Container* and support a rehearing, the White House soon announced an alternative plan.[16]

President Reagan directed the Secretary of the Treasury to establish a "working group" composed of representatives of the federal and state governments and the business community

[16]Pleas for administration support for a rehearing and for congressional legislation and the administrations' reaction are detailed in the Chairman's Report, *supra*, at pages 2-3.

"charged with producing recommendations . . . that will be conducive to harmonious international economic relations, while also respecting the fiscal rights and privileges of the individual states." (Chairman's Rep., *supra*, at p. ii; see also 48 Fed.Reg. 208, p. 49570 (Oct. 26, 1983).) The final report of the working group, released in 1984 as the Chairman's Report, *ante*, footnote 3, recommended efforts by the states to mitigate the international effects of formula apportionment, including limiting its use to the "water's edge," (that is, excluding from the unitary tax base members of foreign-controlled groups not doing business in the United States). Although these state efforts at reform were to be "voluntary," in his transmittal letter to the President, Treasury Secretary Regan stated that "If there are not sufficient signs of appreciable progress by the states in this area by . . . next year, . . . I will recommend to you that the Administration propose federal legislation that would give effect to a water's edge limitation patterned after that in [the report]." (Chairman's Rep., *supra*, at p. iii.)

Eighteen months later, the administration followed up on its threat to seek congressional action. In a November 1985 statement, the President called for federal legislation that would require the states to adopt "water's edge" restrictions on the use of worldwide formula apportionment and directed the Treasury Secretary to "work with the Congress for [its] passage." At the same time, the President directed the Attorney General "to ensure that the United States' interests are represented in appropriate controversies and cases consistent with [the] approach" outlined in the President's statement. (45 Weekly Compilation of Pres. Documents 1368.) In January 1986, Secretary of State Shultz wrote to then-Governor Deukmejian informing him that legislation had been introduced before Congress "at the express direction of the President" that "would prohibit states from taxing corporations under the worldwide unitary method." (Letter of Jan. 30, 1986, from Sect. of State Shultz to Governor Deukmejian.)[17]

[17]Neither the Senate nor the companion House versions of the Treasury Department-drafted legislation were enacted. (See Remarks of

As a result of executive branch initiatives, some states agreed to cease using the formula apportionment method in the case of foreign-parent multinationals.[18] Others, California among them, adopted meliorative measures designed to pacify critics. In 1986, our Legislature enacted "water's edge" legislation,[19] prompting senior Treasury Department officials to retreat from their previous insistence that Congress prohibit state use of worldwide formula apportionment. For the time being, the administration told Congress, neither prohibitory congressional legislation nor treaty restrictions on state use of worldwide unitary methods was appropriate.[20]

As this account rather pointedly makes clear, the struggle for supremacy between the major interests with a stake in the fate of worldwide formula apportionment — states using that method and their federalist allies, on the one hand, and aggrieved multinationals and their supporters in the business community and

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Sen. Wilson on Sen. No. 1974, 131 Cong. Rec. S17975, daily ed. Dec. 18, 1985; remarks of Representative Duncan on H.R. No. 3980, 131 Cong. Rec. E574, daily ed. Dec. 19, 1985.)

On the legal front, the Solicitor General filed a brief amicus curiae in *Wardair, supra*, 477 U.S. 1, supporting the foreign air carrier in its unsuccessful contention that Florida's tax on aviation fuel was unconstitutional under a dormant foreign commerce clause analysis. (*Id.*, at p. 9.)

[18](See, e.g., Langbein, *The Unitary Method and the Myth of Arm's Length, supra*, 30 Tax Notes at p. 674, fn. 1. [by early 1986, four of the twelve states using worldwide unitary methods, "including all of the commercially significant states except California," had repealed them].)

[19](See Rev. & Tax. Code, § 25110 et seq.)

[20](Statement of J. Roger Mentz, Asst. Sect. of the Treas. for Tax Policy, before the Subcom. on Taxation and Debt Management, Sen. Finance Com. (Sept. 29, 1986), at pp. 2-3.) The Assistant Secretary's comments, stating the administration's position on Senate Bill No. 1974 — the Treasury Department-sponsored legislation drawn up at President Reagan's direction — included the view that "Congressional action on S. 1974 should be deferred until the remaining worldwide unitary states have a full opportunity to act . . ." and that "a treaty resolution of the unitary issue is [not] necessary or appropriate at this time." *(Ibid.)*

the executive branch, on the other — has a long history. For much of this history, executive officials have sought unsuccessfully to impose their solution on the states through Senate ratification of a treaty provision embodying curbs and, failing that, legislation enacted under Congress's foreign commerce clause power.

Only late in the campaign have the partisans of separate accounting changed the locus of attack by seeking to have the worldwide use of formula apportionment by the states judicially invalidated on dormant foreign commerce clause grounds. In pressing that challenge, opponents of the worldwide unitary method have marshalled executive branch arguments designed to persuade Congress and the states to legislate curbs, and have attempted to transmute them into the "clear federal directive" of *Container, supra*, 463 U.S. 159.[21] As explained above, however, that doctrine underlines the plenary power of *Congress* to preempt state taxation methods with "foreign resonances"; it does not give executive officials carte blanche to declare state tax methods null when they irritate our trading partners.[22]

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[21]These materials consist largely of numerous diplomatic notes of complaint ("demarches") filed with the United States by its trading partners objecting to the states' use of worldwide formula apportionment, presidential statements, statements and letters from cabinet officers and other senior Treasury and State Department officials to the same effect, and official documents such as the Chairman's Report, *supra*. As noted, there is no doubt that many foreign governments object strenuously to the practice and that executive branch officials charged with conducting American foreign commercial policy agree with them.

[22]We thus reject the claim of the United States Department of Justice, appearing as amicus curiae in support of the Bank, that California's use of formula apportionment in this case is "an egregious interference with the Federal Executive's conduct of foreign affairs and is thus patently unconstitutional." Although we accept the Justice Department's argument that the views of the executive branch on the international effect of state taxation practices are entitled to "great weight" under a foreign dormant commerce clause analysis (cf. *Container, supra*, 463 U.S. at p. 196), our conclusion that such an analysis is not triggered here forecloses resort to those views. (Compare

Conclusion

It is clear that federal limitations on the states' use of worldwide formula apportionment is a controversial political and economic issue of which Congress has long been aware. In light of that history, we cannot turn away from the substantial evidence of Congress's repeated refusal to intervene in the regulation of state division of income methods for tax purposes, even one that provokes continuing international complaint. Under the compulsions of established constitutional doctrine, the courts sometimes are required to divine what foreign commerce policy Congress would pursue in the absence of any indication that it has thought about the subject; it is a quite different matter, however, for a court to ignore a pattern of congressional action that evidences both an awareness of an issue and a refusal to adopt the remedy urged upon it by executive officials and resisted by its state constituencies. The latter, we believe, viewed in context alongside additional treaty materials, is a governmental silence that is eloquent.

In light of Congress's awareness of antagonistic state taxation and international business interests, the path taken by the high court in *Wardair, supra*, 477 U.S. 1, seems the constitutionally correct one here. To invest a paper trail of executive aspiration with the dignity of a "clear federal directive" would, in the language of *Wardair*, "turn dormant Commerce Clause analysis entirely upside down." (*Id.*, at p. 12.) Taking our lead from the high court, we decline to adjudicate on dormant foreign commerce clause grounds a debate between the political branches of the federal government over what is, in both its international and federalist dimensions, a sharply contested issue of national tax policy that has been repeatedly aired before Congress. We adhere to the central meaning of the high court's opinion in *Wardair* in holding that Congress's refusal to legislate restrictions on state use of worldwide formula apportionment is not the sort of governmental silence that triggers a dormant foreign commerce clause analysis.

Wardair, surpa, 477 U.S. at p. 9 [rejecting views of United States as amicus curiae].)

Our holding does not end the matter, however. The trial court held that the cost to a foreign-based unitary enterprise of furnishing financial data required by the Board's use of the worldwide formula apportionment method — the so-called "compliance burden" — violated due process. In addition, it held that same burden violated the nondiscrimination requirement of the four-part dormant interstate commerce clause analysis under *Complete Auto Transit, Inc. v. Brady, supra*, 430 U.S. 274.

The Court of Appeal explicitly declined to decide the due process issue and does not appear to have passed directly on the nondiscrimination issue. The due process issue is a fact-dependent question that should be decided by the Court of Appeal in the first instance; moreover, we think its examination of the issue would profit from a consideration of its merit free of the view that a dormant foreign commerce clause analysis is appropriate in the circumstances present here.

Accordingly, the judgment of the Court of Appeal is reversed and the cause is remanded to that court for further proceedings consistent with this opinion.

ARABIAN, J.

WE CONCUR:

LUCAS, C. J.
MOSK, J.
PANELLI, J.
KENNARD, J.
BAXTER, J.
GEORGE, J.

BARCLAYS BANK INTERNATIONAL, LTD. v.
FRANCHISE TAX BOARD

S019064

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TRIAL COURT:	Sacramento County Superior Court
TRIAL COURT #:	325059

The information provided here is not intended to reflect that which will appear in official reports.

APPENDIX D

CERTIFIED FOR PUBLICATION

COURT OF APPEAL OF THE STATE OF CALIFORNIA
THIRD APPELLATE DISTRICT
(Sacramento)

BARCLAYS BANK INTERNATIONAL LIMITED,
Plaintiff and Respondent,
v.
FRANCHISE TAX BOARD,
Defendant and Appellant.

BARCLAYS BANK OF CALIFORNIA,
Plaintiff and Respondent,
v.
FRANCHISE TAX BOARD,
Defendant and Appellant.

C003388

(Super. Ct. Nos. 325059 & 325061)

November 20, 1992

As Modified on Denial of Rehearings, December 18, 1992.

APPEAL from judgments of the Superior Court of Sacramento County, George E. Paras, Retired Associate Justice of the Court of Appeal, sitting under assignment by the Chairperson of the Judicial Council. Reversed.

John K. Van de Kamp, Attorney General, Timothy G. Laddish, Assistant Attorney General, Robert F. Tyler and Robert D. Milam, Deputy Attorneys General, for Defendant and Appellant.

Joanne M. Garvey, Joan K. Irion, Teresa M. Maloney, and Heller, Ehrman, White & McAuliffe, for Plaintiffs and Respondents.

Lawrence V. Brookes and Valentine Brookes as Amici Curiae for Thorn-EMI PLC and EMI Limited, on behalf of Plaintiffs and Respondents.

Jane H. Barrett, Lawler, Flex & Hall, and F. Eugene Wirwahn as Amici Curiae for the Government of the United Kingdom and the Government of Canada, on behalf of Plaintiffs and Respondents.

David F. Levi, United States Attorney, William S. Rose, Jr., Assistant Attorney General, and Gary R. Allen, David English Carmack, John J. McCarthy, and Richard A. Correa, Attorneys, Department of Justice, as Amicus Curiae for the United States of America, on behalf of Plaintiffs and Respondents.

In this case we originally concluded that California's unitary tax method of worldwide combined reporting (based on Rev. & Tax. Code, §§ 25101, 25120-25139), as applied to foreign-based unitary corporate groups, was unconstitutional under the foreign commerce clause in light of the "one-voice" component of judicially-established dormant foreign commerce clause analysis. (U.S. Const., art. I, § 8, cl. 3; *Japan Line, Ltd. v. County of Los Angeles* (1979) 441 U.S. 434 [60 L.Ed.2d 336, 99 S.Ct. 1813]; *Container Corp. v. Franchise Tax Bd.* (1983) 463 U.S. 159 [77 L.Ed.2d 545, 103 S.Ct. 2933]; *Wardair Canada v. Florida Dept. of Revenue* (1986) 477 U.S. 1 [91 L.Ed.2d 1, 106 S.Ct. 2369].) In *Barclay's Bank Internat. Ltd. v. Franchise Tax Bd.* (1992) 2 Cal.4th 708, the California Supreme Court disagreed with our conclusion and remanded this matter to us. Pursuant to that remand, we have been directed to consider whether the administrative burden for a foreign-based unitary corporate group (such as exemplified by plaintiffs) in complying with worldwide combined reporting violates either the nondiscrimination component of dormant commerce clause analysis (*Complete Auto Transit, Inc. v. Brady* (1977) 430 U.S. 274 [51 L.Ed.2d 326, 97 S.Ct. 1076]; *Japan Line, supra*) or due process. (*Barclay's, supra*, 2 Cal.4th at pp. 742-743.) We conclude that neither of these principles is violated on "compliance burden" grounds by California's application of worldwide combined reporting to plaintiffs in the context of a properly-applied regulation (Cal. Code Regs., tit. 18, § 25137-6) governing such reporting.

BACKGROUND

When a corporation conducts business in more than one jurisdiction, either through branches or subsidiaries, the proper allocation of income for tax purposes becomes an issue. Essentially, two methods of allocating income have evolved to resolve this issue: the arm's length/separate accounting method and the unitary business/formula apportionment method. As to multinational corporations, California employs a common variant of the unitary method called worldwide combined reporting (WWCR).

Under the arm's length/separate accounting method, the various affiliated corporations of a multijurisdictional enterprise are viewed as separate from one another and the income attributable to any particular jurisdiction is determined on the basis of internal accounting records reflecting the activity of the affiliate within that jurisdiction. To preclude tax-manipulative intercorporate transfers of goods, services or other value, this accounting method requires that the tax reporting entity deal at "arm's length" with its affiliated businesses as if they were simply unrelated entities dealing in the marketplace.

In contrast, under the unitary business/formula apportionment method of accounting employed by California (WWCR), the affiliated corporations of a multijurisdictional enterprise are treated as units of a single business—that is, as a "unitary group." (Cal. Code Regs., tit. 18, § 25137-6.) If a corporation doing business in California is deemed to be part of a unitary group, the total income for that group, including corporations or affiliates operating wholly outside California or the United States for that matter, is apportioned to California by a three-factor formula. The formula takes into account property, payroll, and sales (revenue in this case) for the group in California, as a fraction of total worldwide property, payroll, and sales. (See Rev. & Tax. Code, §§ 25128-25136; Note, *State Worldwide Unitary Taxation: The foreign Parent Case* (1985) 23 Columbia Journal of Transnational Law 455, fn. 2 (hereafter 23 Columbia Journal).) The fraction is then multiplied against the unitary group's total income, producing an apportioned amount of such income taxable by California. Because intercorporate transactions are disregarded, it is unnecessary to make "arm's length" adjustments.

The present controversy involves challenges to additional tax assessments for the year 1977 resulting from California's use of WWCR. Those additional assessments were levied after the defendant California Franchise Tax Board (Board or the Board) determined that the plaintiff taxpayers, Barclays Bank of California (Barcal) and Barclays Bank International (BBI), and their ultimate corporate parent, Barclays Bank Limited (BBL), as well as the significant subsidiaries of BBI and BBL, constituted a unitary group. Barcal was directed to pay an additional $152,420 and BBI an additional $1,678. Under protest Barcal and BBI (referred to collectively as plaintiffs) paid the additional taxes and this suit ensued.

DISCUSSION

1. *The Sufficiency of Plaintiffs' Claims for Refund*

As a preliminary matter, the Board contends that plaintiffs are foreclosed from litigating the compliance burden as it relates to the commerce clause and the due process clause because these issues were not set forth in plaintiffs' claims for refund. We disagree.

The California Constitution in article XIII, section 32 provides that "[a]fter payment of a tax claimed to be illegal, an action may be maintained to recover the tax paid, with interest, in such manner as may be provided by the Legislature." (See *Shiseido Cosmetics (America) Ltd. v. Franchise Tax Bd.* (1991) 235 Cal.App.3d 478, 486-488.) Pursuant to this constitutional authority, the Legislature has provided the procedures for seeking refunds in cases such as this one. Under Revenue and Taxation Code section 26074 (all further statutory references are to this code), a claim for refund must state the specific grounds upon which it is based. A taxpayer can bring an action only upon these grounds. (§ 26102.) In fact, courts are without jurisdiction to consider grounds not set forth in the claim. (*Atari Inc., v. State Bd. of Equalization* (1985) 170 Cal.App.3d 665, 672.) This is because the specific constitutional source of legislative power to control tax refund suits mandates strict adherence to the administrative procedures set forth by the Legislature before a court

action can be filed. (See *Shiseido Cosmetics (America), supra,* 235 Cal.App.3d at p. 488; *Patane v. Kiddoo* (1985) 167 Cal.App.3d 1207; *Woosley v. State of California* (1992) 3 Cal. 4th 758).

Here, plaintiffs did not file claims for refund as such. Instead, they filed written protests against proposed additional taxes (§ 25664) which were transformed by law into claims for refund. (§ 26078.) Under section 26078, if a taxpayer pays the protested tax before the Board decides the protest, the protest is treated as a claim for refund. Like a claim for refund, a section 25664 protest must specify the grounds upon which it is based.

The plaintiffs set forth the following grounds in their consolidated protests based on the commerce clause and due process clause:

> "The Foreign Commerce Clause of the federal Constitution and treaties prohibit application of the unitary filing to the taxpayer.
>
> "Whether the Commerce Clause of the United States Constitution limits the taxation of a unitary business to income derived from activities carried on within the United States.
>
> "Whether the Due Process . . . Clause[ ] of the United States Constitution limit[s] the application of the California method of reporting and tax to activities carried on within the United States because of arbitrary and unreasonable distortions created by including non-U.S. source income in the tax base or because the method falls unfairly on taxpayers owned by foreign affiliates whose income is used as a measure of the tax."

We think these stated grounds are sufficient to encompass the "compliance burden" issues. The protests allege that California's *method of reporting falls unfairly* on taxpayers owned by foreign affiliates. The direct implication of this language is that foreign-based unitary groups bear an unfair burden in complying with WWCR. Two decisions provide some guidance regarding the specificity required for a refund claim. In *Wallace Berrie & Co. v. State Bd. of Equalization* (1985) 40 Cal.3d 60, the court con-

cluded that a particular issue had been raised in the claim although it was set forth only indirectly. (*Id.* at p. 66, fn. 2.) In *King v. State Bd. of Equalization* (1972) 22 Cal.App.3d 1006, this court deemed a refund claim's assertion of "'erroneously and illegally' collected and computed taxes" far too diffuse to meet the specificity requirement. (*Id.* at p. 1015.) The "refund claim" here is more akin to the one in *Wallace Berrie* than to the one in *King*.

The Board spends considerable effort in arguing that this court's decision in *Shiseido* should apply here. (BSB 3-16) But that case is distinguishable. In *Shiseido*, there was *no* refund claim because the tax was paid after the protest proceedings were final and therefore the prepayment protest could not be considered such a claim. (235 Cal.App.3d at pp. 491-492; see § 26078.) In fact, *Shiseido* distinguished *Wallace Berrie* by noting that "*Wallace Berrie* has no application to this case, where there was no refund claim." (*Id.* at p. 492.)

Consequently, we conclude the plaintiffs have adequately set forth the compliance burden in the appropriate constitutional contexts. We proceed to consider that burden in the context of the commerce clause and the due process clause.

2. *The Nondiscrimination Requirement in the Complete Auto-Japan Line Dormant Commerce Clause Test*

Article I, section 8, clause 3 of the United States Constitution gives Congress the power "To regulate commerce with foreign nations, and among the several states, . . ." The commerce clause not only grants Congress the authority to regulate commerce among the states and with foreign nations, but also directly limits the power of states to discriminate against interstate or foreign commerce. (*New Energy Co. v. Limbach* (1988) 486 U.S. 269, 273 [100 L.Ed.2d 302, 308, 108 S.Ct. 1803]; *Container, supra*, 463 U.S. at p. 170.) This latter limitation is within the "'negative'" aspect of the commerce clause. (*New Energy Co., supra.*) States are prohibited from discriminating against foreign commerce in order to ensure that such commerce remains the province of federal oversight and that individual states do not work to the detriment of the nation as a whole. (*Wardair, supra*,

477 U.S. 1; see *Maryland v. Louisiana* (1981) 451 U.S. 725, 754 [68 L.Ed.2d 576, 600, 101 S.Ct. 2114].) When Congress has not acted or purported to act in a situation implicating the commerce clause, the judiciary engages in "dormant" commerce clause analysis under the "negative" aspect of the clause. (*Merrion v. Jicarilla Apache Tribe* (1982) 455 U.S. 130, 154-155 [71 L.Ed.2d 21, 40, 102 S.Ct. 894]; *Barclay's, supra*, 2 Cal.4th at p. 725, fn. 9.)

In *Japan Line, supra*, 441 U.S. 434, the "dormant" foreign commerce clause test of constitutional review was formulated. That test incorporates, among other things, the test for dormant interstate commerce clause review. (*Id.* at pp. 444-445.) The latter test upholds a state tax against an interstate commerce clause challenge if the tax "'[i] is applied to an activity with a substantial nexus with the taxing State, [ii] is fairly apportioned, [iii] does not discriminate against interstate commerce, and [iv] is fairly related to the services provided by the State.'" (441 U.S. at pp. 444-445, 449, 454, quoting *Complete Auto Transit, supra*, 430 U.S. at p. 279.) Our concern is with the discrimination component of this test.

The California Supreme Court decided in *Barclay's* that a dormant foreign commerce clause analysis was unnecessary, concluding that Congress in effect had acted and decided not to prohibit states from applying the WWCR unitary tax method to foreign-based unitary corporate groups. (2 Cal.4th at pp. 741-742.) Taking a general view, then, it is unnecessary to engage in dormant commerce clause analysis here. However, viewing the issue more specifically, the court in *Barclay's* carefully focused on the components peculiar to the dormant foreign commerce clause analysis, especially the one-voice component. The *Barclay's* court did not address, as did the trial court, the discrimination component incorporated from the dormant interstate commerce clause test of *Complete Auto* into the dormant foreign commerce clause test of *Japan Line*. For that reason, we will consider the merits of the discrimination issue as applied to plaintiffs.[1]

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[1] In its remand, the court in *Barclay's* stated: "Our holding does not end the matter, however. The trial court held that the cost to a foreign-

The principles which guide our analysis are culled largely from decisions involving the effect of state taxes on interstate commerce. *Japan Line's* incorporation of the interstate commerce clause discrimination component validates its use in the foreign commerce context. (See also *Container, supra,* 463 U.S. at p. 170.)

Under that component, a state may not impose a tax which discriminates against foreign commerce either by providing a "direct commercial advantage" to domestic commerce or by subjecting foreign commerce to multiple taxation.[2] (*Portland Cement Co. v. Minnesota* (1959) 358 U.S. 450, 458 [3 L.Ed.2d 421, 427, 79 S.Ct. 357]; *Maryland, supra,* 451 U.S. at p. 754; *Boston Stock Exchange v. State Tax Comm'n* (1977) 429 U.S. 318, 329 [50 L.Ed.2d 514, 97 S.Ct. 599]; see *Kraft Foods v. Iowa Dept. of Rev.* (1992) 505 U.S. ___ [120 L.Ed.2d 59, 65, 67-68; 112 S.Ct. 2365].) A state discriminates against foreign commerce if it imposes a burden on that commerce which is not imposed on domestic or in-state commerce, or if it favors domestic/in-state commerce without a comparable favor for foreign commerce. (*Kraft Food, supra,* 120 L.Ed.2d at p. 68; *American Trucking Associations, Inc. v. Larson* (3d Cir. 1982) 683 F.2d 787, 798, fn. 10.) A finding that a state tax discriminates may be made on the basis of either discriminatory purpose or discriminatory effect. (*Bacchus Imports, Ltd. v. Dias* (1984) 468 U.S. 263, 270 [82 L.Ed.2d 200, 208].)[3]

based unitary enterprise of furnishing financial data required by the Board's use of the worldwide formula apportionment method—the so-called 'compliance burden'—violated due process. In addition, it held that same burden violated the nondiscrimination requirement of the four-part dormant interstate commerce clause analysis under *Complete Auto Transit, Inc. v. Brady, supra,* 430 U.S. 274. [¶] The Court of Appeal explicitly declined to decide the due process issue and does not appear to have passed directly on the nondiscrimination issue. The due process issue is a fact-dependent question that should be decided by the Court of Appeal in the first instance; moreover, we think its examination of the issue would profit from a consideration of its merit free of the view that a dormant foreign commerce clause analysis is appropriate in the circumstances present here." (2 Cal.4th at p. 742.)

[2] In the compliance burden context presented here, there is no issue of multiple taxation. (See also *Container, supra,* 463 U.S. at pp. 189-193.)

Foreign-based corporate groups incur greater administrative costs to comply with California's WWCR system than do their domestic-based counterparts. In a nutshell, this distinction between domestic and foreign-based multinationals is a result of the following: while domestic-based multinationals keep most of their records in English, in United States currency and in accord with United States accounting and tax accounting principles, the same cannot be said for multinationals based abroad. (See Comptroller General Report, *Key Issues Affecting State Taxation of Multijurisdictional Corporate Income Need Resolving,* 3, GAO/GGD-82-38 (1982), p. 39.) For the foreign parent, some of the information may not be available because different nations use different accounting methods. (See 23 Columbia Journal, p. 471.) The information that does exist is not always in the language, in the currency, and in accord with the accounting principles just noted. Significant costs are incurred in obtaining the necessary information on a worldwide basis, and translating

[3] The recent United States Supreme Court decision in *Kraft Foods* did not hold that the "direct commercial advantage" principle enshrined in interstate commerce clause analysis (see *Portland Cement Co., supra,* 358 U.S. at p. 458) is irrelevant in the foreign commerce clause discrimination context. Instead, *Kraft* rejected the claim that since Iowa businesses do not receive a commercial advantage over foreign commerce under Iowa's tax system, that system does not violate the discrimination component of the foreign commerce clause test. (120 L.Ed.2d at pp. 65, 67-68.) As the court in *Kraft* noted: "[W]e think that a State's preference for domestic commerce over foreign commerce is inconsistent with the Commerce Clause even if the State's own economy is not a direct beneficiary of the discrimination. As the absence of local benefit does not eliminate the international implications of the discrimination, it cannot exempt such discrimination from Commerce Clause prohibitions." (*Id.* at p. 68.)

Following up this theme, the court in *Kraft* reiterated that if Iowa's tax statute "does not favor business activity in the United States generally over business activity abroad . . . this would indeed suggest that the statute does not discriminate against foreign commerce." (120 L.Ed.2d at p. 68.)

and transforming it to these modes. (See Comment, *California's Corporate Franchise Tax: Taxation of Foreign Source Income?* (1980) 20 Santa Clara L.Rev. 123, 143-144; 23 Columbia Journal at p. 471.)

The question is whether this distinction in "compliance burden" comprises an unconstitutional discrimination against plaintiffs. We conclude it does not.

The California WWCR unitary tax method does not discriminate against foreign-based unitary groups by providing a "direct commercial advantage" to in-state/domestic-based unitary groups. Under that method, both groups are treated the same—they face the same tax rate and must furnish the same kind of information. (Rev. & Tax. Code, §§ 25101, 25120-25138; Cal. Code Regs., tit. 18, § 25137-6.) It is well-settled that a multijurisdictional enterprise " 'must pay its way' " regarding state taxation. (See 9 Witkin, Summary of Cal. Law (9th ed. 1989) Taxation, § 64, p. 84 and cases cited therein.) Therefore, a foreign-based multijurisdictional enterprise, in complying with a particular jurisdiction's taxation scheme, must always present its tax information in the language, currency and accounting principles the authorities in that jurisdiction understand. This does not constitute a *direct* commercial advantage to unitary groups based in that jurisdiction. At most, it constitutes an indirect cost inherent in doing business in *foreign* lands.

It is argued that domestic-based unitary groups, as opposed to foreign-based groups, must already compile the information required by the California WWCR tax method to comply with federal tax laws. This, however, does not render the WWCR method unconstitutionally discriminatory. Discrimination against foreign-based commerce entails imposing a burden on such commerce which is not imposed on domestic-based commerce, or favoring domestic commerce without a comparable favor for foreign commerce. (*Kraft Food, supra,* 120 L.Ed.2d at p. 68; *American Trucking, supra,* 683 F.2d at p. 798, fn. 10.) Under California's WWCR tax method, no burden is imposed on foreign-based commerce which is not imposed on domestic-based commerce and no favor is granted domestic commerce which is denied to foreign commerce. *American Trucking* illustrates this

point well. In that case, a Pennsylvania statute requiring that all motor carriers be periodically inspected was challenged on interstate commerce clause grounds. The plaintiffs argued that the statute discriminated against out-of-state motor carriers because Pennsylvania motor carriers "were already subject to" a state inspection program. (*Ibid.*) The court disagreed, noting that no discriminatory burdens were imposed on out-of-state carriers and no discriminatory favors were granted Pennsylvania carriers. (*Ibid.*)[4] In any event, the constitutionality of California's WWCR tax method must be examined on its own—its constitutionality cannot depend on the "shifting complexities" of the federal tax laws. (See *Armco Inc. v. Hardesty* (1984) 467 U.S. 638, 644-645 [81 L.Ed.2d 540, 547].)

Moreover, cost of compliance has not traditionally been thought of as constitutionally-determinative in the commerce clause context. As noted in *Bibb v. Navajo Freight Lines* (1959) 359 U.S. 520 [3 L.Ed.2d 1003], "Cost *taken into consideration with other factors* might be relevant in some cases to the issue of

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[4] *Hunt v. Washington Apple Advertising Comm'n* (1977) 432 U.S. 333 [53 L.Ed.2d 383], cited by the trial court, is distinguishable in this respect. In that case, a North Carolina statute was invalidated as an unconstitutional discrimination against out-of-state commerce. The statute required all closed containers of apples sold in North Carolina to display either the applicable U.S.D.A. grade or no classification. State grades were expressly prohibited. This requirement was *inconsistent* with the practice of Washington state apple growers whose containers were preprinted with a state grade classification that was at least the equivalent of, and in many cases superior to, the U.S.D.A. grade. (432 U.S. at pp. 336-337.) The discrimination resulted from the fact that North Carolina apple producers, unlike their Washington competitors, were not forced to alter established marketing practices in order to comply with the statute. (432 U.S. at p. 351; see *American Trucking, supra,* 683 F.2d at p. 798, fn. 10.) By contrast, both foreign-based multinationals and domestic-based multinationals are saddled with the same kind of burden in complying with California's WWCR tax method because they must both furnish the same kind of information. In line with the principle enunciated in *American Trucking,* it does not matter that domestic-based multinationals are "already subject to" a procedure for which they must gather this information.

burden on commerce." (*Id.* at p. 526, emphasis added; see also *Raymond Motor Transportation, Inc. v. Rice* (1978) 434 U.S. 429, 445 [54 L.Ed.2d 664, 677]: "The regulations substantially increase the cost of [interstate movement of goods], a fact which is not . . . entirely irrelevant.") Although *Bibb* and *Raymond* involved highway safety regulations where compliance costs may weigh less in the balance (see *Brotherhood v. Chicago, R. I. & P. R. Co.* (1968) 393 U.S. 129, 140 [21 L.Ed.2d 289, 297-298]), the two decisions illustrate that administrative costs of compliance, alone, are generally insufficient to be deemed an unconstitutional burden. (See *Bibb, supra,* at p. 526; *Brotherhood, supra,* at p. 140.) It is one thing to invoke cost of compliance *as a factor* bearing on the risk of foreign retaliation, such risk itself being only a factor in determining whether foreign policy is implicated under the "one-voice" component of dormant foreign commerce clause analysis. (See *Container, supra,* 463 U.S. at p. 195.) It is quite another thing to invoke administrative cost of compliance as the single determinant of unconstitutional discrimination against foreign-based unitary groups.

In *Northwestern States Portland Cement Company v. Minnesota, supra,* 358 U.S. 450, the court upheld, against a commerce clause challenge, a state tax law that levied taxes on that portion of an out-of-state corporation's net income earned from business activities that were within the taxing state but exclusively in furtherance of interstate commerce. (358 U.S. at pp. 452, 461-463.) Justice Frankfurter, in dissent, believed the law unconstitutionally burdened interstate commerce in part because "there are thousands of relatively small or moderate size corporations doing exclusively interstate business spread over several States. To subject these corporations to a separate income tax in each of these States means that they will have to keep books, make returns, store records, and engage legal counsel, all to meet the divers and variegated tax laws of forty-nine States, . . . This will involve large increases in bookkeeping, accounting, and legal paraphernalia to meet these new demands. The cost of such a far-flung scheme for complying with the taxing requirements of the different States may well exceed the burden of the taxes themselves, . . ." (*Id.* at p. 474.) Although the majority opinion did not explicitly address Justice Frankfurter's point on cost of compli-

ance, that opinion did note that the tax at issue did not "discriminate against nor subject [the] corporation[s] to an undue burden," and that "[i]n this type of case the taxpayers must show . . . a burden upon interstate commerce in a constitutional sense. This they have failed to do." (*Id.* at pp. 461, 463.)

In determining whether a tax law imposes a "discriminatory burden" on foreign commerce (see *Boston Stock Exchange, supra,* 429 U.S. at p. 331), how the law works in its "practical operation" rather than its label or appearances will control the decision. (*Nippert v. Richmond* (1946) 327 U.S. 416, 425, 431 [90 L.Ed. 760, 765, 769]; 9 Witkin, Summary of Cal. Law, *supra,* Taxation, § 65, p. 85.) As stated in *Nippert,* "Not the tax in a vacuum of words, but its practical consequences for the doing of interstate commerce in applications to concrete facts are our concern." (327 U.S. at p. 431.) Plaintiffs argue that "literal compliance" with the WWCR tax method is cost-prohibitive. In light of the principle set forth in *Nippert,* however, this argument loses much of its force. The application of the WWCR method to unitary businesses with foreign country operations is guided by California Code of Regulations, title 18, section 25137-6. Under that regulation, the Board, in computing the income and the apportionment formula factors for a combined report, "shall consider the effort and expense required to obtain the necessary information. In appropriate cases, such as when the necessary data cannot be developed from financial records maintained in the regular course of business, the . . . Board may accept reasonable approximations;" moreover, taxpayers can seek "advance determination[s]" under any provision of the regulation.[5] Here, the record shows that the plaintiffs and the Board used these provisions and that computations based on reasonable approximations were made. Practically-speaking, therefore, the plaintiffs did not have to "comply literally." Applying the concrete facts here, it is evident that "literal compliance" is a "label" or "appearance" not controlling to the relevant practical determination involving the

[5] At trial, the parties and the court used the term "literal compliance" to mean the application of the WWCR regulation (section 25137-6) without the relief clauses of "reasonable approximations" and "advance determination." (§ 25137-6, subds. (e)(1) and (e)(2).)

commerce clause in this case. In any event, the evidence showed that "literal compliance" was cost-prohibitive for domestic-based unitary corporate groups as well. The domestic-based and foreign-based groups therefore stand on relatively equal footing regarding "literal compliance." Consequently, such compliance cannot serve as a *discriminatory* burden against the foreign-based groups.[6]

In short, the burden for plaintiffs in complying with California's unitary tax method of WWCR did not involve "the type of differential tax treatment" that results in an unconstitutional discrimination under the foreign commerce clause test set forth in *Complete Auto* and *Japan Line*. (See *Commonwealth Edison Co. v. Montana* (1981) 453 U.S. 609, 618 [69 L.Ed.2d 884, 894].)[7].

3. *The Due Process Clause*

In this context, there are two issues relating to "compliance burden": first, whether the WWCR administrative cost of compliance to plaintiffs is unreasonable, undue or arbitrary; and second, whether the WWCR compliance process is without reasonably adequate standards to guide enforcement. At trial, the focus was on the second issue.

Largely for the reasons expressed in our discussion above, we cannot say the WWCR administrative cost of compliance to

[6] This "practical operation" focus does not foreclose a tax law being invalidated as discriminatory on its face. (*Memphis Steam Laundry v. Stone* (1952) 342 U.S. 389, 395 [96 L.Ed. 436, 441]; see *Bacchus Imports, Ltd., v. Dias, supra*, 468 U.S. at p. 268.) California's unitary tax method of WWCR does not discriminate on its face against foreign-based corporate groups. (See Cal. Code Regs., tit. 18, § 25137-6.)

[7] In a recent case our Supreme Court used the *Complete Auto* discrimination test to hold that California discriminated against interstate commerce by imposing higher license fees on out-of-state vehicles and by imposing higher use taxes on vehicles purchased from private parties in other states. (*Woosley v. State of California, supra*, 3 Cal 4th 781, 783.) The *Woosley* court found this discrimination to be a patent violation of the commerce clause. (*Id.* at pp. 778, 781.) As we have explained above, no such discrimination is implicated here.

plaintiffs is unconstitutionally unreasonable, undue or arbitrary. (See *Portland Cement, supra*, 358 U.S. at pp. 452, 461, 463, 474.) There is no evidence in the record that a nonarbitrary application of the section 25137-6 WWCR regulation results in such a cost.

As for the second issue, the trial court stated as follows: "Plaintiffs claim that because an element of the WWCR [Cal. Code Regs., tit. 18, § 25137-6] calls for materiality, reasonable approximations, and advance determinations, all at the unfettered discretion of [the Board], with no guidelines, there is a violation of the due process clauses (both U.S. and California) insofar as the tax relates to a foreign multinational. [¶] The WWCR regulation [§ 25137-6] is not on its face uncertain, nor does the approximation segment make it uncertain. Its taxing rules are sufficiently clear and understandable to satisfy due process. The discretionary advance determination, reasonable approximation, and materiality rules (materiality does not really belong in this thought—it is inherent and essential in every tax scheme) are only there to the extent a taxpayer seeks to avail himself of them. They are not imposed willy-nilly. [¶] What does constitute a due process violation is the fact that all witnesses agreed that with customarily and currently available accounting data, literal compliance with WWCR requirements is impossible for foreign multi-nationals such as Plaintiffs, and the only way to 'comply' is by supplication and negotiation (absent an unduly burdensome cost of compliance). There is no reasonable certainty and no judicial reason to believe that whatever the taxpayer considers reasonable or material will be so treated by the [Board].... [¶] Thus I conclude that WWCR as applied to Plaintiffs violates due process, both federal and state. (C.F. *Chy Lung v. Freeman* (1876) 92 U.S. 275; *Grayned v. Rockford* (1972) 408 U.S. 104; *McDonnell Douglas Corp. v. Franchise Tax Bd.* (1968) 69 C2 506)."

We agree with the trial court that California Code of Regulations, title 18, section 25137-6 (hereafter, section 25137-6) is not on its face uncertain and that its taxing rules are sufficiently clear and understandable to satisfy due process. We disagree with the trial court that section 25137-6 violates due process by allowing

"unfettered discretion" in the tax authorities in the wake of "literal compliance." We conclude the regulation can be construed to contain constitutionally-adequate standards to guide application.[8]

[8] Section 25137-6 provides in pertinent part: "(1) Unitary Business. A taxpayer is engaged in a unitary business (or a single business within the meaning of Reg. 25120(b)) when its activities within the state contribute to or are dependent upon its activities without the state. A unitary business exists when there is unity of ownership, unity of operation and unity of use.

"(2) Translation Method for Determining Income. The translation method to be used for determining income shall be the 'profit and loss method' as set forth in this regulation. . . .

"(3) General Applicability of UDITPA Regulations. The general regulations for UDITPA, Regs. 25120-25139, inclusive, shall be applicable except as otherwise provided in this regulation.

"(b) Determination of income.

"(1) The income of a unitary business with operations in foreign countries shall be computed in the following manner:

"(A) A profit and loss statement shall be prepared for each foreign branch or corporation in the currency in which the books of account of the branch or corporation are regularly maintained.

"(B) Adjustments shall be made to the profit and loss statement to conform it to the accounting principles generally accepted in the United States for the preparation of such statements except as modified by this regulation.

"(C) Adjustments shall be made to the profit and loss statement to conform it to the tax accounting standards required under Division 2, Part 11 of the Revenue and Taxation Code.

"(D) The profit and loss statement of each branch or corporation, whether U.S. or foreign, shall be translated into the currency in which the parent company maintains its books and records in accordance with subsection (b)(4).

" . . .

"(2) In lieu of the procedures set forth in subsection (b)(1) and subject to the determination of the Franchise Tax Board that it reasonably reflects income, a unitary business with operations in a foreign country may determine its income on the basis of the consolidated profit and loss statement prepared for the related corporations of which the unitary business is a member which is prepared for filing with the Securities and Exchange Commission. If the business is not required to file with the Securities and Exchange Commission, the consolidated profit and loss statement prepared for reporting to shareholders and subject to review by an independent auditor may be used.

(C) No adjustment shall be required under subsections (b)(3)(A) [accounting adjustments] and (b)(3)(B) [tax accounting adjustments] unless it is material. Whether an adjustment is material depends upon the facts and circumstances of the particular case, including the amount of the adjustment, its size relative to the general level of the corporation's total assets and annual profit or loss, the consistency with which the practice has been applied, and whether the item to which the adjustment relates is of a recurring or a nonrecurring nature.

" . . .

"(e) Application of Regulation.

"(1) In computing the income and any of the factors required for a combined report, the Franchise Tax Board shall consider the effort and expense required to obtain the necessary information. In appropriate cases, such as when the necessary data cannot be developed from financial records maintained in the regular course of business, the Franchise Tax Board may accept reasonable approximations.

"(2) A taxpayer may request an advance determination under subsections (b)(2) [consolidated SEC/shareholder profit and loss statement], (b)(3)(C) [materiality], (c)(1) [exchange rates], (d)(1) [computation of property factor] or any other provision of this regulation by submitting a determination request to the Legal Division of the Franchise Tax Board. Such a determination shall be made on an individual basis and shall be limited to the particular facts or circumstances set forth in the determination request. The facts and circumstances upon which a determination is made remain subject to review. Failure to request or to obtain a favorable advance determination will not preclude consideration of requested variances in subsequent proceedings."

"Administrative regulations are subject to the same rules of construction and interpretation that apply to statutes." (*Organization of Deputy Sheriffs v. County of San Mateo* (1975) 48 Cal.App.3d 331, 341.) So long as the regulation was properly adopted and does not transgress its statutory derivation, it " 'comes before the court with a presumption of correctness and regularity.' " (*L.A.J., Inc. v. State Bd. of Equalization* (1974) 38

Cal.App.3d 549, 553; see *Parfums-Corday, Inc. v. State Bd. of Equalization* (1986) 187 Cal.App.3d 630, 636.)

Nevertheless, to pass muster under the federal and state due process clauses, a regulation must provide reasonably adequate standards to guide enforcement. (*Fisher v. City of Berkeley* (1984) 37 Cal.3d 644, 702; *Britt v. City of Pomona* (1990) 223 Cal.App.3d 265, 278.) Government regulation must be sufficiently clear so that it is understandable and does not encourage arbitrary and discriminatory application. (*Chalmers v. City of Los Angeles* (9th Cir. 1985) 762 F.2d 753, 757; *Grayned v. City of Rockford* (1972) 408 U.S. 104, 108 (33 L.Ed.2d 222, 227); *Morrison v. State Board of Education* (1969) 1 Cal.3d 214, 231, fn. 30.) A statute, and hence a properly-adopted regulation, will not be held void for uncertainty if any reasonable and practical construction can be given its language. (*Fletcher v. Western National Life Ins. Co.* (1970) 10 Cal.App.3d 376, 405; see *California Housing Finance Agency v. Elliott* (1976) 17 Cal.3d 575, 594.) Vagueness is less a concern if an enterprise has the ability to clarify the meaning of an economic regulation in advance by resort to an administrative process. (*Chalmers, supra,* 762 F.2d at p. 757; *Village of Hoffman Estates v. Flipside, Hoffman Estates, Inc.,* (1982) 455 U.S. 489, 498 [71 L.Ed.2d 362].)

The central concern here involves subsection (e) of section 25137-6, entitled "Application of Regulation" and providing: "(e)(1) In computing the income and any of the factors required for a combined report, the Franchise Tax Board shall consider the effort and expense required to obtain the necessary information. In appropriate cases, such as when the necessary data cannot be developed from financial records maintained in the regular course of business, the Franchise Tax Board may accept reasonable approximations. [¶] (2) A taxpayer may request an advance determination under any . . . provision of this regulation by submitting a determination request to the Legal Division of the Franchise Tax Board. Such a determination shall be made on an individual basis and shall be limited to the particular facts or circumstances set forth in the determination request. The facts and circumstances upon which a determination is made remain

subject to review. Failure to request or to obtain a favorable advance determination will not preclude consideration of requested variances in subsequent proceedings."

The trial court held that with "literal compliance" in the wings, "[t]here is no reasonable certainty and no judicial reason to believe that whatever the taxpayer considers reasonable or material will be so treated by the [Board]," and that "the only way to 'comply' [with the WWCR method] is by supplication and negotiation." We disagree and conclude that the discretion vested in the Board under section 25137-6 to accept reasonable approximations and to make materiality and advance determination decisions is subject to reasonably adequate standards to guide enforcement as that regulation is interpreted herein.

Initially, we must consider the relevance of "literal compliance" in this case in its factual and legal contexts. The evidence here showed that "literal compliance" was more an abstraction than a matter of how the WWCR method was actually applied. Plaintiffs and the Board used reasonable approximations and readily-accessible corporate documents in the WWCR process. Plaintiffs' cost in filing under the WWCR system in the 1970's was shown to be relatively modest.[9] And there is no evidence the Board arbitrarily (as opposed to mistakenly) applied section 25137-6 to plaintiffs.

The legal context invoked here concerns the multijurisdictional allocation of income. It is long-since settled that a multijurisdictional enterprise "must pay its way" to each jurisdiction contributing to the flow or derivation of value. (See 9 Witkin, Summary of Cal. Law, *supra,* Taxation, § 64, p. 84.) The difficult task is how to assign a particular value to a particular jurisdiction for tax

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[9] For BBI, on the order of $900 to $1,250 per year for three annual tax returns filed in the 1970's. In 1977, the tax year in question, BBI was engaged in business directly or through its approximately 70 subsidiaries in 55 countries. These tax return filing fees do not encompass BBL which, in addition to owning BBI and BBI's subsidiaries, owned 140 additional subsidiaries and operated in 5 additional countries. Thus, in 1977, BBI and its subsidiaries comprised approximately one-third the total number of subsidiaries within the BBL unitary group.

purposes. Although the general premise of "paying one's own way" is widely-accepted and intuitively-sound, the application of this premise graphically exemplifies the old adage that the "devil is in the details." As stated in *International Harvester Co. v. Evatt* (1947) 326 U.S. 416, 422 [91 L.Ed. 390, 395], "this Court has long realized the practical impossibility of a state's achieving a perfect apportionment of expansive, complex business activities . . . and has declared that 'rough approximation rather than precision' is sufficient." Our Supreme Court, in *McDonnell Douglas, supra*, 69 Cal.2d at p. 511, echoed this theme by quoting from *El Dorado Oil Works v. McColgan* (1950) 34 Cal.2d 731, 741, as follows: " 'No method of allocation can precisely determine the amount of income attributable either to any given geographic area or to any given part of a series of business transactions culminating in the realization of a profit, and "any effort" in that regard "must be more or less arbitrary and fictitious" [citation] as a matter of practical tax administration.' " Finally, as the court in *Container* recognized, "Both geographical accounting [i.e., separate accounting] and formula apportionment [i.e., WWCR] are imperfect proxies for an ideal which is not only difficult to achieve in practice, but also difficult to describe in theory." (463 U.S. at p. 182.)

It is these factual and legal recognitions that make "literal compliance" less relevant and practical administrative discretion more significant in the WWCR due process equation presented here. (See also *Amoco Production Company v. Arnold* (Kan. 1974) 518 P.2d 453, 464 ["the allocation and apportionment of the income of a multistate corporation is a subject for administrative expertise in accord with statutory direction"]; Wahrhaftig, *Allocation Factors in Use in California* (1960) 12 Hastings L.J. 65, 92.) In this way, "literal compliance" cannot be considered the overriding factor of whether the due process clause has been violated in this case; however, the Board must still be subject to reasonably adequate standards to guide its application of the factors in section 25137-6 regarding reasonable approximation, materiality and advance determination. (*Fisher, supra*, 37 Cal.3d at p. 702; *Britt, supra*, 223 Cal.App.3d at p. 278.) As we construe that section, those standards are present.

Under section 25137-6, subsection (e)(1), the Board, in computing the income and the factors required for WWCR, must consider the effort and expense for the taxpayer in obtaining the necessary information. In appropriate cases, the Board may accept reasonable approximations "such as when the necessary data cannot be developed from financial records maintained in the regular course of business." (*Ibid.*) It is this mandatory consideration of effort and expense against the backdrop of data development from regularly-maintained documents that circumscribes the Board's discretion under section 25137-6 and provides a framework for meaningful judicial review if the Board arbitrarily exercises that discretion. As the-regulation notes, examples of these regularly-maintained documents include profit and loss statements filed with the Securities and Exchange Commission or profit and loss statements prepared for shareholders and subject to review by independent auditors. (§ 25137-6, subd. (b)(2).) In light of these examples, we find that section 25137-6 does not contemplate an intricate, time-consuming and expensive data development process. In short, the Board must consider the cost and effort of producing WWCR information in deciding whether to accept reasonable approximations, and that consideration is to use regularly-maintained or other readily-accessible corporate documents as the cost guideline. Given this, we also find that a court can determine, on a principled basis, whether the Board is acting arbitrarily in refusing to use reasonable approximations or in requesting certain information, information that can be compared easily to these generally-understood records. (See *Fisher, supra*, 37 Cal.3d at p. 703; on the general issue of judicial review in the administrative tax proceeding context, see *People ex. rel. Franchise Tax Bd. v. Superior Court* (1985) 164 Cal.App.3d 526, 545-546; *Aronoff v. Franchise Tax Board* (1963) 60 Cal.2d 177, 179-180; see also *California v. Grace Brethren Church* (1982) 457 U.S. 393, 417 [73 L.Ed.2d 93, 112].)

It must also be noted that the Board's discretion takes place in the application of an apportionment formula that the court in *Container* described as "something of a benchmark against which other apportionment formulas are judged." (463 U.S. at p. 170.) And the statutory basis of section 25137-6, Revenue & Taxation Code section 25137, is itself built on a "reasonable" foundation

subject to the Board's discretion; this discretion was validated in the *McDonnell Douglas* decision. (69 Cal.2d at pp. 511-512.)

Nor is the standard of "reasonable," in the context presented here, so formless as to constitute a violation of due process. "Reasonable" is a standard peppered throughout the law, and is an appropriate standard in the context of multijurisdictional allocation of income arising from expansive, complex business activities. In this context, " 'rough approximation rather than precision' " has been deemed sufficient, and any effort in this regard has been recognized to " 'be more or less arbitrary and fictitious' . . . as a matter of practical tax administration." (*International Harvester Co., supra,* 329 U.S. at p. 422; *McDonnell Douglas Corp., supra,* 69 Cal.2d at p. 511.) In the tax arena, the United States Supreme Court has upheld against a due process vagueness challenge a tax conviction premised on the standard of a " 'reasonable allowance for salaries' " for business deduction purposes. (*United States v. Ragen* (1942) 314 U.S. 513, 524 [86 L.Ed. 383, 390].) The Court noted that "[d]etermination of allowable deductions by reference to a standard of 'reasonableness' is not unusual under federal income tax laws," and that such a standard, even applied in a (proper) penal context, is not too vague to afford a practical guide to permissible conduct. (*Id.* at pp. 522-523; see also Note, *The Void-For-Vagueness Doctrine In The Supreme Court* (1960) 109 U.Pa.L.Rev. 67.)

In fact, the system plaintiffs advocate employs a standard akin to reasonable approximation. The federal system of separate accounting determines and allocates income to related businesses in a multijurisdictional enterprise by estimating what transaction costs would be incurred were the companies unrelated and dealing at arms-length. (26 U.S.C. § 482.) Indeed, tax authorities are given broad discretion to make these determinations. (*Dolese v. C.I.R.* (10th Cir. 1987) 811 F.2d 543, 546; *Peck v. C.I.R.* (9th Cir. 1985) 752 F.2d 469, 471-472.) These determinations will not be overturned unless they are shown to be arbitrary, capricious, or unreasonable. (*Ibid.*) Plaintiffs argue that 26 U.S.C. section 482, unlike the WWCR procedure, does not encompass a tax system based entirely on approximations. But the section 482 process goes to the heart of the federal income tax system for related

businesses by allocating the income, deductions, credits or allowances for the respective businesses to prevent evasion of taxes or to reflect income clearly. (26 U.S.C., § 482; *Peck, supra,* at p. 471.) In this way, both WWCR and section 482 significantly use approximations to determine income.

Finally, there is no evidence here that the Board arbitrarily applied the reasonable approximation standard while dangling plaintiffs over the "literal compliance" flame. There is evidence the Board made a mistake in the approximating process, but the Board and plaintiffs were working substantively in that process. The trial court cautioned that "[b]ureaucratic mistakes and excesses are always possible." That is true. But it is also true that such mistakes and excesses can be remedied through administrative or judicial review. As previously noted, the Board's discretion regarding reasonable approximations is circumscribed and guided by our interpretation of section 25137-6(e)(1)'s mandatory consideration of cost and effort. (See *Grayned v. City of Rockford, supra,* 408 U.S. at p. 108; *Morrison v. State Board of Education, supra,* 1 Cal.3d at p. 231, fn. 30; *Fisher v. City of Berkeley, supra,* 37 Cal.3d at p. 702.)

We conclude the Board's "reasonable approximations" discretion is subject to reasonably adequate standards to guide application and therefore is not unconstitutional under the state or federal due process clause. (*Fisher, supra,* 37 Cal.3d at pp. 702-703; *Britt, supra,* 223 Cal.App.3d at p. 278.)

That brings us to the Board's discretion regarding materiality determinations. The question of materiality asks whether certain differences—generally regarding different accounting or tax accounting practices—are material or immaterial to the overall tax computation. (See § 25137-6, subds. (b)(1)(B), (b)(1)(C), (b)(2)(A), (b)(3)(C).) As the trial court rightfully acknowledged, the concept of materiality is inherent and essential in every tax scheme. Section 25137-6 sets forth specific guidelines for materiality determinations. Under the regulation, "[W]hether an adjustment is material depends upon the facts and circumstances of the particular case, including the amount of the adjustment, its size relative to the general level of the corporation's total assets and annual profit or loss, the consistency with which the practice

has been applied, and whether the item to which the adjustment relates is of a recurring or a nonrecurring nature." (§ 25137-6, subd. (b)(3)(C).) As with reasonable approximations, the Board's discretion in determining whether something is material cannot be made arbitrarily or capriciously. (See *Chalmers, supra,* 762 F.2d at p. 757; *Grayned, supra,* 408 U.S. at p. 108; *Morrison, supra,* 1 Cal.3d at p. 231, fn. 30.) There is no reason to believe that will occur in light of these provisions guiding that discretion. We conclude the Board's "materiality" determinations are subject to reasonably adequate standards to guide application and therefore are not unconstitutional under the state or federal due process clause. (*Fisher, supra,* 37 Cal.3d at p. 702; *Britt, supra,* 223 Cal.App.3d at p. 278.)

The third challenged area of Board discretion concerns "advance determination." Under section 25137-6, subsection (e)(2), "[a] taxpayer may request an advance determination under . . . any . . . provision of this regulation by submitting a determination request to the Legal Division of the Franchise Tax Board. Such a determination shall be made on an individual basis and shall be limited to the particular facts or circumstances set forth in the determination request. The facts and circumstances upon which a determination is made remain subject to review. Failure to request or to obtain a favorable advance determination will not preclude consideration of requested variances in subsequent proceedings."

The problem for plaintiffs on this issue is that an avenue of advance administrative determination usually undermines rather than supports a due process challenge for uncertainty or unfettered discretion. (See *Chalmers, supra,* 762 F.2d at p. 757; *Village of Hoffman Estates v. Flipside, Hoffman Estates, Inc., supra,* 455 U.S. at p. 498.) This is particularly true here where the avenue is so wide. Under subsection (e)(2), the taxpayer may request an advance determination under any provision of the regulation and the Board is obligated to act substantively on that request. Moreover, subsection (e)(2) provides that "[f]ailure to request or to obtain a favorable advance determination will not preclude consideration of requested variances in subsequent proceedings." The Board's discretion is tempered by this provision

since the taxpayer can raise the point again. And the Board's discretion regarding the meaning of or decisions on "reasonable approximations" and materiality is tempered by this advance determination option.

The cases relied upon by plaintiffs and the trial court in this respect are either distinguishable or compatible with our reasoning. The statute invalidated in *Chy Lung v. Freeman* (1876) 92 U.S. 275 [23 L.Ed. 550] gave the California Commissioner of Immigration the power " 'To satisfy himself whether or not any passenger who shall arrive in the State by vessels from any foreign port or place (who is not a citizen of the United States) is lunatic, idiotic, deaf, dumb, blind, crippled or infirm, and is not accompanied by relatives who are able and willing to support him, or is likely to become a public charge, or has been a pauper in any other country, or is from sickness or disease (existing either at the time of sailing from the port of departure or at the time of his arrival in the State) a public charge, or likely soon to become so, or is a convicted criminal, or a lewd or debauched woman;' " and to prohibit any such person from landing unless financial arrangements, in many cases accruing to the benefit of the Commissioner, were made. (23 L.Ed. at p. 551.) As the *Chy Lung* court noted, "[i]t is hardly possible to conceive a statute more skillfully framed, to place in the hands of a single man the power to entirely prevent vessels engaged in a foreign trade, say with China, from carrying passengers, or to compel them to submit to systematic extortion of the grossest kind." (*Ibid.*) In *Joseph Burstyn, Inc. v. Wilson* (1952) 343 U.S. 495 [96 L.Ed. 1098] and similar cases, the authorities were vested with significant discretion in sensitive areas such as free speech or free assembly. (See Note, *The Void-For-Vagueness Doctrine, supra,* 109 U.Pa.L.Rv. at p. 82, fn. 78.) For example, in *Burstyn,* a statute was invalidated that allowed a government censor to ban a film if he concluded it was "sacrilegious." (343 U.S. at p. 506.) Section 25137-6, as we have construed it, does not involve the unbridled discretion or subjective power in sensitive areas exemplified in *Chy Lung* and *Burstyn.*

In its due process analysis, the trial court also cited the decisions in *Grayned v. City of Rockford, Supra,* and *McDonnell*

Douglas Corp. v. Franchise Tax Bd., Supra. We too have relied on these decisions and they are compatible with our reasoning: *Grayned* because it is the widely-cited decision which sets forth the basic principle (in construing an anti-noise penal ordinance) that to prevent arbitrary and discriminatory enforcement, laws must provide explicit standards for those who apply them; and *McDonnell Douglas* because it illustrates the soundness of broad but rationally-guided administrative discretion in the inherently muddled area of multijurisdictional tax allocation. (See also Wahrhaftig, *Allocation Factors* in *Use* in *California*, 12 Hastings L.J., *supra*, at p. 92; *Amoco Production Co. v. Armold, supra*, 518 P.2d at p. 464.)

Indeed, it is the contexts exemplified in *Grayned* and *McDonnell Douglas* which distinguish the final case upon which plaintiffs rely: *Weissinger v. Boswell* (1971) 330 F.Supp. 615. On due process grounds, the court in *Weissinger* invalidated an Alabama statute that granted tax officials wide discretion in the setting of ad valorem assessment rates—the officials were permitted to use rates ranging from 0 to 30 percent of fair market value. (*Id.* at pp. 619, 625.) The court noted that a reasonable degree of certainty and definiteness is required in a tax statute. (*Id.* at p. 624.)

The *Weissinger* principle regarding a reasonable degree of certainty is sound and we have interpreted the "compliance burden" portion of section 25137-6 with its view in mind. Nevertheless, the context in which that principle is applied must be considered. "The degree of vagueness that the Constitution tolerates—as well as the relative importance of fair notice and fair enforcement—depend in part on the nature of the enactment." (*Hoffman Estates, supra*, 455 U.S. at p. 498.) In *Weissinger*, the challenged tax was on real property. Real property is tangible, unmovable, solely within one sovereign jurisdiction for tax purposes, and capable of precise administration. These attributes, by contrast, comprise almost the antithesis of the tax system we encounter here. As the court in *Container* aptly put it, "[b]oth geographical accounting [i.e., separate accounting] and formula apportionment [i.e., WWCR] are imperfect proxies for an ideal which is not only difficult to achieve in practice, but also difficult to describe in theory." (463 U.S. at p. 182.) At this stage in the

debate, all thoughtful people agree that multijurisdictional enterprises have to pay their way in their respective jurisdictions. And everyone agrees that geographical accounting or formula apportionment are the only two general methods available to determine the amount to be paid. It is in this inherently imprecise context, then, that we must apply the due process principles on vagueness as they pertain to administrative burden.

CONCLUSION

We emphasize the narrow scope of our decision. We have concluded that the administrative burden to plaintiffs in complying with WWCR in the context of a proper application of the WWCR regulation, section 25137-6, violates neither the nondiscrimination component of dormant commerce clause analysis set forth in *Complete Auto* and *Japan Line* nor state or federal due process. As part of our compliance burden analysis in the due process context, we have concluded that the discretion vested in the Board under section 25137-6 to accept "reasonable approximations" and to make materiality and advance determination decisions is subject to reasonably adequate standards to guide application as that regulation is interpreted herein. There is no evidence in the record that the Board applied these aspects of section 25137-6 to plaintiffs in an arbitrary, discriminatory or unreasonable way. Consequently, these aspects of section 25137-6, as applied to plaintiffs, did not violate due process.

DISPOSITION

The judgment is reversed and the trial court is directed to enter a judgment for Board. Each party shall bear its own costs on appeal.

DAVIS, J.

We concur:

PUGLIA, P.J.

SPARKS, J.

APPENDIX E

Third Appellate District No. C003388
S019064

IN THE SUPREME COURT OF
THE STATE OF CALIFORNIA
IN BANK

BARCLAYS BANK INTERNATIONAL LIMITED ETC.,
Respondent
v.
FRANCHISE TAX BOARD OF THE STATE OF CALIFORNIA,
Appellant.

Respondent's petition for review DENIED.

Kennard, J. is of the opinion the petition should be granted.

LUCAS
Chief Justice

Filed February 18, 1993

Robert Wandruff, Clerk
Deputy

APPENDIX F

CONSTITUTIONAL AND STATUTORY PROVISIONS INVOLVED

UNITED STATES CONSTITUTION

Article I, Section 8, Clause 3 of the United States Constitution (the Commerce Clause) provides that:

> The Congress shall have power ... [t]o regulate Commerce with foreign Nations, and among the several States, and with the Indian Tribes.

Article VI, Clause 2 of the United States Constitution (the Supremacy Clause) provides that:

> The Constitution, and the Laws of the United States which shall be made in Pursuance thereof; and all Treaties made, or which shall be made, under the Authority of the United States, shall be the supreme Law of the Land; and the Judges in every State shall be bound thereby, any Thing in the Constitution or Laws of any State to the contrary notwithstanding.

Amendment XIV, Section I of the United States Constitution (the Due Process Clause) provides:

> [N]or shall any State deprive any person of life, liberty, or property, without due process of law.

CALIFORNIA REVENUE AND TAXATION CODE

§ 25101. When the income of a taxpayer subject to the tax imposed under this part is derived from or attributable to sources both within and without the state the tax shall be measured by the net income derived from or attributable to sources within this state in accordance with the provisions of Article 2 (commencing with Section 25120). However, any method of apportionment shall take into account as income derived from or attributable to sources without the state, income derived from or attributable to transportation by sea or air without the state, whether or not the transportation is located in or subject to the jurisdiction of any other state, the United States or any foreign country.

If the Franchise Tax Board reapportions net income upon its examination of any return, it shall, upon the written request of the taxpayer, disclose to it the basis upon which its reapportionment has been made.

§ 25137. If the allocation and apportionment provisions of this act do not fairly represent the extent of the taxpayer's business activity in this state, the taxpayer may petition for or the Franchise Tax Board may require, in respect to all or any part of the taxpayer's business activity, if reasonable:

(a) Separate accounting;

(b) The exclusion of any one or more of the factors;

(c) The inclusion of one or more additional factors which will fairly represent the taxpayer's business activity in this state; or

(d) The employment of any other method to effectuate an equitable allocation and apportionment of the taxpayer's income.

APPENDIX G

RULE 29.1 LIST
BARCLAYS' LESS THAN 100% OWNED SUBSIDIARIES

Subsidiary	Ownership Interest
Europe Asia Dynamic Fund Management Co. SA	70.00%
Barclays Pizano Y Recoder	55.00%
Puget-Mahe SA	97.00%
Comigestion SA	97.00%
Puget-Mahe Contrepartie SA	97.00%
Massey-Ferguson Leasing Ltd.	75.00%
NB Geotech Finance Ltd.	51.00%
Fiatagri Finance Ltd.	51.00%
Barmac (Estates) Ltd.	50.10%
Blocksite Ltd.	50.20%
Bramingham Park Ltd.	50.10%
Chadacre Developments Ltd.	50.10%
Charmtape Ltd.	50.10%
Growlimit Ltd.	50.10%
J.V. Developments Ltd.	50.10%
Loopbeam Ltd.	50.10%
Mervest (Hendon) Ltd.	70.00%
Mervest (Sloane) Ltd.	51.00%
PSA Credit Company Ltd.	50.01%
Regmore Developments Ltd.	50.20%
Regmore Homes Ltd.	50.10%
Royco Business Parks Ltd.	50.10%
Wates-Barclays-Mercantile Homes Ltd.	50.01%
Wadham Stringer Credit Company Ltd.	75.00%
Barclays Motor Finance Ltd.	75.00%
Barclays Motor Wholesale Pty. Ltd.	75.00%
Barclays Bank of Botswana Ltd.	74.86%
Barclays Pensions Management Consultants (Pty.) Ltd.	74.86%
Barclays Bail SA	99.99%
Barclays Gestion SA	99.99%
Barclays Immobilier SARL	99.95%
Barclays Invest Ltd.	99.00%
Barclaymur SA	99.90%
Financiere Laffitte	99.99%
Laffitte Capital	99.99%
Laffitte Patrimoine	99.97%
Laffitte Gastion	99.80%
Laffitte Investissement	99.99%
Laffitte Securities SA	99.99%
S.A.G.O.	99.83%

Subsidiary	Ownership Interest
S.C. Des Garages du 21 Rue Laffitte	57.50%
Lutetia Societe Financiere SA	99.94%
Soc de credit Pour acquisition et amelioration des Immeubles	99.98%
S.F.G.C. (Group Barclays)	99.99%
Immogestion Barclays SA	95.04%
Society Civile Immobiliere Barclays IMMO-Hexagone	99.93%
Card Finanz Systeme AG	84.99%
Barclays Bank of Ghana Ltd.	60.00%
Barclays Bank of Ghana Forex Bureau Ltd.	60.00%
Barclays Bank of Kenya Ltd.	68.50%
Barclays Advisory and Services Ltd.	68.50%
Barclays (Kenya) Nominees Ltd.	68.50%
Barclays Merchant Finance Ltd.	68.50%
Spread Eagle Services Limited	68.50%
Barclays Bank of Serra Leone Ltd.	60.00%
Barclays Bank S.A.	91.22%
BARGES SA	91.22%
Ruval SA	91.22%
Segunda Banlid de Inversion Immobiliaria SA (SEBANSA)	91.22%
Barclays Leasing SA	91.22%
Barclays Entidad De Financiacion, SA	91.22%
Terbansa, SA	91.22%
Barclays Correduria de Seguros SA	91.22%
Barclays Bank of Swaziland Ltd.	60.00%
Barclays Bank of Uganda Ltd.	51.00%
Barclays Bank of Uganda (Foreign Exchange Bureau) Ltd.	51.00%
Barclays Bank of New York, NA[1]	99.90%
Societe d'Exploitation et de Gestion Immobiliere au Zaire	51.25%
Barclays Bank of Zimbabwe Ltd.	70.00%
Barclays Vie S.A.	99.99%
Barclays Zimbabwe Nominees (Pvt) Ltd.	70.00%
Barclaytrust (Pvt) Ltd.	70.00%
Claydon Holdings, Inc.	95.00%
Claydon Properties, Inc.	95.00%

[1] Barclays Bank of New York, N.A. has a number of 100 percent owned subsidiaries, not listed here.

APPENDIX H

IN THE SUPREME COURT OF
THE STATE OF CALIFORNIA

BARCLAYS BANK INTERNATIONAL LTD., et al.,
Plaintiffs and Respondents,
v.
FRANCHISE TAX BOARD
of the State of California,
Defendant and Appellant.

No. S019064
3 Civ. No. C003388
(Consolidated with 3 Civ. No. C003389)

After Decision by the Court of Appeal
Third Appellate District

Sacramento County Superior Court Nos. 325059 and 352061
The Honorable George E. Paras, Judge Pro Term

BRIEF AMICUS CURIAE OF THE
UNITED STATES IN SUPPORT OF
PLAINTIFFS AND RESPONDENTS

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IN THE SUPREME COURT OF
THE STATE OF CALIFORNIA

BARCLAYS BANK INTERNATIONAL LTD., et al.,
Plaintiffs and Respondents,
v.
FRANCHISE TAX BOARD
of the State of California,
Defendant and Appellant.

No. S019064
3 Civ. No. C003388
(Consolidated with 3 Civ. No. C003389)

AMICUS CURIAE BRIEF OF THE UNITED STATES IN SUPPORT OF PLAINTIFFS AND RESPONDENTS BARCLAYS BANK INTERNATIONAL LTD., AND BARCLAYS BANK OF CALIFORNIA

ISSUE PRESENTED

Whether California's utilization of the worldwide unitary apportionment formula method of allocating income among multinational corporations engaged in foreign commerce in order to determine the taxable income of members of a foreign owned multinational group of corporations is unconstitutional in that it interferes with the Federal Government's conduct of foreign affairs in violation of the Foreign Commerce Clause.

INTEREST OF THE UNITED STATES

The power to regulate foreign commerce is reserved exclusively to the United States. Further, the Federal Executive has exclusive authority to conduct the foreign affairs of the United States, and pursuant to that authority can agree with foreign nations as to the norms and practices with respect to international commerce among nations. States may not engage in any practice which expressly conflicts with any act of the United States in these areas, or even implicates the United States' regulation of foreign commerce and conduct of foreign policy. In short the states may

not impair the right of the United States to speak with "one voice" in conducting and controlling foreign relations and international commerce.

This *amicus curiae* brief is submitted by the United States to protect that interest. It is the position of the United States that California's worldwide unitary income allocation method of taxation may not constitutionally be applied to the taxpayers (plaintiffs-respondents) without impairing the ability of the United States to speak with one voice in conducting and controlling foreign relations and international commerce.

STATEMENT

The instant case involves California's application of the worldwide unitary apportionment formula method of allocation of income to a unitary business group consisting of a foreign parent corporation and its subsidiaries. The California Franchise Tax Board interprets California law (Cal. Rev. & Tax. Code Secs. 230001 *et seq.*), and the regulations promulgated thereunder[1] to require that taxation of the income of corporations doing business in California, if the corporations are determined to be engaged in a "unitary" worldwide business enterprise, be measured by the worldwide income of the foreign parent and all of its subsidiaries, even those which are not domiciled and do no business in the United States. California first began to so measure income of unitary business groups in 1972. (CT. 1738.)[2]

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[1]California's statutes do not expressly provide for the allocation of income of related corporations on the basis of the worldwide unitary business concept method, but rather this method of allocation of income has been adopted by the California Franchise Tax Board in enforcing and administering California's corporate tax statutes. This method of taxation is designated as the "WWCR" (Worldwide Combined Reporting) method in the opinion of the Court of Appeal.

[2]"CT." references are to the record in the trial court as paginated by the clerk of the trial court which the parties have stipulated can be used as the record on this appeal.

a. *The implication of applying the worldwide unitary apportionment formula in the Federal Government's conduct of foreign policy.*

Income of multinational corporations has been identified and allocated to taxing jurisdictions by two different methods: (1) the worldwide combined reporting unitary method utilized by California and by several other states, and (2) the international standard, the separate accounting or "arm's length" adjustment method.[3] It is the expressed policy of the United States that the separate accounting or "arm's length" method is the appropriate method of allocating income among commonly controlled multinational corporations. (CT. 1740-1742.) This view has been adopted in the United States Internal Revenue Code (26 U.S.C., Section 482)[4] and is embodied in virtually all bilateral tax treaties that have been entered into by the United States. (CT. 1742.)[5] The

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[3]The transactional or geographical basis of taxation is commonly called the "arm's length" method of taxation because the taxpayer corporation is treated as a unit doing business with every other corporation and entity on an "arm's length" basis even though the other corporations are parents, subsidiaries or sister corporations. This method is designated as the "AL/SA" (Arms Length/Separate Accounting) method in the opinion of the Court of Appeal.

[4]Section 482 of the Internal Revenue Code was amended by Section 1231(e) of the Tax Reform Act of 1986, Pub. L. No. 99-514, 100 Stat. 2085, to provide that income from transfers of intangibles between related parties was to be "commensurate with the income attributable to the intangible." The Department of the Treasury and the Internal Revenue Service have advised the Department of Justice that their "study" or "White Paper" on transfer pricing concludes that this amendment is fully consistent with the arm's length standard. See, *A Study of Intercompany Pricing*, prepared jointly by Department of Treasury and the Internal Revenue Service, October 18, 1988.

[5]The United States has bilateral income tax treaties with 40 nations: Income Tax Treaty with Australia, May 14, 1953, T.I.A.S. No. 2880; Income Tax Treaty with Austria, October 25, 1956, T.I.A.S. No. 3923; Income Tax Treaty with Barbados, December 31, 1984, T.I.A.S. No. 11090; Income Tax Treaty with Belgium, July 9, 1970, T.I.A.S. No. 7463; Income Tax Treaty with Canada, August 16, 1984, T.I.A.S.

No. 11087; Income Tax Treaty with Cyprus, March 19, 1984, T.I.A.S. No. 98-32; Income Tax Treaty with Denmark, May 6, 1948, T.I.A.S. No. 1854; Income Tax Treaty with Finland, December 30, 1990, S. Exec. Rept. No. 101-11; Income Tax Treaty with France, November 24, 1978, T.I.A.S. No. 9500; Income Tax Treaty with the Federal Republic of Germany, September 17, 1965, T.I.A.S. No. 5920; Income Tax Treaty with Greece, February 20, 1950, T.I.A.S. No. 2902; Income Tax Treaty with Hungary, February 12, 1979, T.I.A.S. No. 9560; Income Tax Treaty with Iceland, May 7, 1975, T.I.A.S. No. 8151; Income Tax Treaty with India, December 18, 1990, S. Exec. Rept. 101-5; Income Tax Treaty with Indonesia, December 30, 1990, S. Exec. Rept. 100-22; Income Tax Treaty with Ireland, September 13, 1949, T.I.A.S. No. 2356; Income Tax Treaty with Italy, April 17, 1984, T.I.A.S. No. 11064; Income Tax Treaty with Jamaica, May 21, 1980, T.I.A.S. No. 10207; Income Tax Treaty with Japan, March 8, 1971, T.I.A.S. No. 7365; Income Tax Treaty with Korea, June 4, 1976, T.I.A.S. No. 9506; Income Tax Treaty with Luxembourg, December 18, 1962, T.I.A.S. No. 5726; Income Tax Treaty with Malta, March 21, 1980, T.I.A.S. No. 10567; Income Tax Treaty with Morocco, August 1, 1977, T.I.A.S. No. 10195; Income Tax Treaty with the Netherlands, April 29, 1948, T.I.A.S. No. 1855; Income Tax Treaty with the Netherlands Antilles, October 23, 1963, T.I.A.S. No. 5665; Income Tax Treaty with New Zealand, November 2, 1983, T.I.A.S. No. 10772; Income Tax Treaty with Norway, December 3, 1971, T.I.A.S. No. 7474; Income Tax Treaty with Pakistan, July 1, 1957; T.I.A.S. No. 4232; Income Tax Treaty with People's Republic of China, October 22, 1986, S. Exec. Rept. 99-7 and S. Exec. Rept. No. 99-15; Income Tax Treaty with Poland, October 8, 1974; T.I.A.S. No. 8486; Income Tax Treaty with Republic of the Philippines, October 1, 1976; T.I.A.S. No. 10417; Income Tax Treaty with Romania, December 4, 1973, T.I.A.S. No. 8228; Income Tax Treaty with Spain, November 21, 1990, S. Exec. Rept. 101-16; Income Tax Treaty with Sweden, March 23, 1939, T.I.A.S. No. 958; Income Tax Treaty with Switzerland, May 24, 1951, T.I.A.S. No. 2316; Income Tax Treaty with Trinidad and Tobago, January 9, 1970, T.I.A.S. No. 7047; Income Tax Treaty with Tunisia, December 26, 1990, S. Exec. Rept. 99-13 and S. Exec. Rept. No. 101-9; Income Tax Treaty with the USSR, June 20, 1973, T.I.A.S. No. 8225; Income Tax Treaty with the United Arab Republic, August 24, 1980, T.I.A.S. No. 10149; Income Tax Treaty with the United Kingdom, December 31, 1975, T.I.A.S. No. 9682.

In particular, Article 9(1) of the United States-United Kingdom convention provides:

"arm's length" is the international norm. That standard has been adopted by international organizations that have addressed transfer pricing issues including the United Nations and the Organization for Economic Cooperation and Development (OECD).[6] Virtually every major industrial nation relies on the arm's length standard in transfer pricing cases. (Letter at 1.)[7]

Application by states of the worldwide combined unitary method of taxation conflicts directly with this federal policy and international standard. The conflict between this state practice and federal policy is clearly articulated in the November 8, 1985, statement of President Reagan on this subject.[8] President Reagan's statement demonstrates the Federal Executive's determination that the state taxing practice in question should be curtailed either by the states themselves, by the judiciary or if necessary by federal legislation. Further, in this statement the President instructed the Attorney General to ensure that this policy and the

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> 1. Where an enterprise of a Contracting State is related to another enterprise and conditions are made or imposed between the two enterprises in their commercial or financial relations which differ from those which would have been made between independent enterprises, then any income, deductions, receipts, or outgoings which would, but for those conditions, have been attributed to one of the enterprises but by reason of those conditions have not been so attributed, may be taken into account in computing the profits or losses of that enterprise and taxed accordingly.

[6]See Organization for Economic Co-operation and Development Committee on Fiscal Affairs, *Transfer Pricing and Multinational Enterprises* (1979); *United States Model Double Taxation Convention between Developed and Developing Countries*, Commentary to Article 5 (1980).

[7]A copy of the letter to Governor Deukmejian of California, dated January 30, 1986, from Secretary of State George P. Schultz is contained in Appendix A, *infra*. This letter was entered into evidence in this case by stipulation of the parties dated September 9, 1986. (Stip. 46(h).)

[8]A copy of the statement is attached hereto as Appendix B, *infra*, and has been entered into evidence in these cases by stipulation of the parties dated September 9, 1986. (Stip. 36(a).)

interest of the United States were represented in appropriate legal cases.

In letters dated January 30, 1986, to the governors of six states of the United States which employ the worldwide unitary method of taxation (Alaska, California, Idaho, Montana, New Hampshire and North Dakota) from the Secretary of State, George P. Schultz, the United States has informed the governors that the state's employment of worldwide unitary method of tax accounting is at odds with the position the United States has taken in the conduct of foreign affairs, and has become a source of conflict with foreign nations. (Letter.)

That the utilization of the unitary method of allocation of income interferes with the conduct of foreign policy is graphically demonstrated by the fact that the Ambassadors of Australia, Belgium, Canada, Denmark, France, the Federal Republic of Germany, the United Kingdom, Greece, Ireland, Italy, Japan, Luxembourg, the Netherlands and Switzerland in a diplomatic note have advised the United States that the unitary method of taxation constitutes "a serious obstacle to the further development of our trade and investment relationships." (Letter at 2.) In addition, the Parliament of the United Kingdom in July, 1985, adopted legislation providing for retaliation against United States corporations which operate in the worldwide unitary tax states. This legislation denies parent corporations doing business in states which employ the unitary tax method tax credits on the taxes they pay to the United Kingdom on account of dividends paid in England by their subsidiaries and imposes substantial penalties on them.[9] These credits reflect the income taxes the United Kingdom subsidiaries pay with respect to the income they distributed as dividends. These credits are provided for under the United States-United Kingdom bilateral income tax convention. The United Kingdom has not yet invoked this legislation, but its

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[9]United Kingdom Finance Bill, Clause 27, adopted by the House of Commons July 10, 1985, House of Commons Official Report. Parliamentary Debates (Hansard) 1014-18 (10 July 1985). See also Letter at 3. That legislation contains a provision making possible the retroactive imposition of heavy penalties.

enactment is a clear indication of the adverse impact of the unitary method of taxation on the conduct of foreign economic relations by the United States. The filing of an *amicus curiae* brief in these cases in the courts below on behalf of the United Kingdom and the arguments against the unitary tax method made in those briefs are additional evidence of the negative impact of the California unitary tax system on the conduct of foreign policy by the United States.

b. *The application of the worldwide unitary apportionment formula to the taxpayers in these consolidated cases.*

The plaintiffs involved herein are Barclays Bank International, Limited (BBI) and Barclays Bank of California (Barcal). During the tax year in question (1977) BBI, a corporation organized under the laws of the United Kingdom, operated an international banking business in a number of countries including the United States (Appellant Br. 3.)[10] BBI was during the period in issue a wholly owned subsidiary of Barclays Bank Limited, also a corporation organized under the laws of the United Kingdom. *(Ibid.)*[11] BBI operated directly in California and as such was subject to regulation by the State of California. Barcal was a California banking corporation, a wholly-owned subsidiary of BBI during the tax years at issue, doing a general retail banking business only in California. *(Ibid.)* As plaintiffs were doing business in California they were subject to taxation by the United States and the State of California.

For the tax year 1977 Barcal filed a tax return with the Franchise Tax Board which reported all the income it earned which was only from California sources and thus fully taxable by California. This return was based upon the separate accounting method and hence none of its income was apportioned. BBI filed a return for the year 1977 with the Franchise Tax Board which reported not only the income BBI earned from California sources

[10] "Appellant Br." references are to pages in Appellant's Opening Brief on this appeal.

[11] In 1985 BBI and Barclays Bank Limited merged under the laws of the United Kingdom to form Barclays Bank PLC.

but also included: (1) income BBI earned from operating bank agencies and branches in the United Kingdom and approximately 33 nations or territories outside of the United Kingdom, including California; and (2) the income earned by 70 subsidiaries of BBI which operated in 34 nations or territories outside of the United Kingdom. (Appellant Br. 3.) BBI's California tax return was based upon the worldwide combined reporting method, and the income reported thereon was apportioned to California using the three-factor formula method as applicable to banks. (Appellant Br. 3.)

The California Franchise Tax Board upon audit of these returns determined that Barcal and BBI were members of a worldwide unitary business conducted by all members of the Barclay Group which included: (1) Barcal, a wholly-owned subsidiary of BBI doing business only in California; (2) BBI, a United Kingdom Corporation doing general retail and commercial banking in the United Kingdom and 34 other nations or territories outside the United Kingdom, including California; (3) the subsidiaries of BBI in which BBI has more than a 50% interest; (4) Barclays Bank Limited, a United Kingdom corporation which conducts no business in California and which owns 100 % of the stock of BBI; and (5) the subsidiaries of Barclays Bank Limited in which that corporation holds more than a 50% interest. (Appellant Br. 3-4.) The California Franchise Tax Board then calculated BBI's and Barcal's tax by allocating a portion of the total income of the above unitary group to these two taxpayers utilizing a three-factor apportionment formula.

Under the three-factor apportionment formula, the in-state corporation's income is calculated as a percentage of the total income of the group of related corporations. After the unitary business group is identified, the in-state corporation's sales, property, and payroll are expressed as a fraction of the total sales, property, and payroll of the unitary group; these three fractions are arithmetically averaged, and this average when multiplied against worldwide group income, yields the taxable income of the in-state corporation. Thus, the apportionment to the in-state corporation of a percentage of the total income of the unitary group is a mathematical function of the income of the total

unitary business group, including those members of the unitary business group operating outside the taxing state.

Utilizing the above method of taxation, proposed tax assessments were issued. (Appellant Br. 5.) The taxpayers claimed this taxation to be improper as it was based not only on their income but also on the income of their foreign parent and upon the income of other foreign subsidiaries of their parent who do not do business in California or elsewhere in the United States. These taxpayers protested the proposed assessments to the Franchise Tax Board, and thereafter paid the proposed tax assessments and sued for a refund of these taxes in the California Superior Court for Sacramento County. (Appellant Br. 5.) One of the grounds raised by the taxpayers in these refund suits was that the Foreign Commerce Clause of the United States Constitution prohibited the application of the worldwide unitary business three-factor formula method for computing the income of the taxpayers. (Appellant Br. 7.)

The trial court entered a judgment and opinion in favor of the taxpayers on August 20, 1987. (CT. 1687, 1716.) This decision rested upon the trial court's conclusion that California's computation of the taxes in question using the worldwide combined unitary business group reporting and three-factor method of apportioning the business group's income to California sources was impermissible as it discriminated against foreign commerce (CT. 1751), violated due process (CT. 1755, 1756) and because it contravened the Foreign Commerce Clause of the United States Constitution as it impeded the Federal Government's ability to speak with one voice in the conduct of foreign affairs, an area wherein federal uniformity is necessary (CT. 1738, 1746, 1747, 1749, 1758-1760).

Thereafter the Franchise Tax Board appealed to the Court of Appeal of California in and for the Third Appellate District and that Court on November 30, 1990, affirmed the decision of the trial court. 255 Cal.App.3d 1342. That court held (1) there was no affirmative federal policy permitting California's use of "worldwide combined reporting" and therefore a dormant Foreign Commerce Clause analysis was in order (Slip Opinion, pp. 23-30); (2) California's use of "worldwide combined reporting" implicated foreign policy issues which must be left to the federal government (Slip Opinion, pp. 31-41); and (3) California's use of "worldwide combined reporting" frustrated the United States' ability to speak one voice in an area of foreign affairs wherein federal uniformity was necessary, and therefore it violated the Foreign Commerce Clause. (Slip Opinion, pp. 41-52.) The Court of Appeal denied the Franchise Tax Board's timely petition for rehearing, and on February 28, 1991, this Court granted the Franchise Tax Board's petition for review.

The instant *amicus curiae* brief supports the trial court's and the Court of Appeal's conclusion that California's application of its worldwide unitary business concept and apportionment formula method of allocating income among a unitary business group controlled by a foreign parent corporation is unconstitutional under the Foreign Commerce Clause as it impairs the ability of the United States to speak with one voice in an area of foreign affairs wherein federal uniformity is necessary.

SUMMARY OF ARGUMENT

BBI, a British corporation, and its subsidiary, Barcal, a California corporation, are engaged in the banking business in California. BBI is the wholly owned subsidiary of Barclays Bank Limited, a British corporation. The California Franchise Tax Board determined that BBI and Barcal were part of a worldwide unitary business and determined their income for 1977 under the worldwide unitary method of taxation. Under that method, the income of all companies that were engaged in a unitary business, including the British parent of BBI and that parent's 50 percent owned subsidiaries that did no business in California, were combined, after eliminating intercompany transactions, to determine the net income of the unitary business. This net income was then apportioned to California on the ratio of the unitary business' California property, payroll and sales to the unitary business' total property, payroll and sales. The issue presented in this case is whether California's unitary taxation method as applied in determining the tax liability of a foreign corporation and its subsidiary that do business in California represents an unconstitutional burden upon, and interference with, foreign commerce. The Superior Court and

the Court of Appeal held, *inter alia*, that the unitary taxation method as applied in the instant cases was unconstitutional because the tax constitutes an impermissible interference in the conduct of the nation's foreign affairs. We agree and submit that that reason alone warrants affirmation of the judgment of the Court of Appeal below.

Under the Commerce Clause of the United States, a state may not, when imposing an income-based tax, tax value outside its border. The state may, however, constitutionally tax on an apportioned basis the total income and property of a corporation earning income in, and moving its property through, multiple taxing jurisdictions. The test for constitutionality of a tax imposed on an apportioned basis under the dormant interstate commerce clause is: (1) there must be a substantial nexus between the state and the activity or property taxed; (2) the activity or property must be fairly apportioned to the taxing state; (3) the tax must not discriminate against interstate commerce; and (4) the tax must be fairly related to the services provided by the state. When, however, the state tax is challenged under the dormant Foreign Commerce Clause, two additional questions must be addressed to determine the constitutionality of the tax: (1) whether the tax creates a substantial risk of international multiple taxation, and (2) whether the tax prevents the Federal Government from speaking with one voice when regulating commercial relations with foreign governments. Because the tax in question fails under the second test, it is unnecessary to address any other tests.

The Federal Constitution has conferred upon the Federal Government the exclusive power to represent this nation in matters of foreign affairs. The United States and its foreign trading partners have consistently used the "arm's length" standard in allocating income between nations. Although the Court, in *Container Corporation of America v. Franchise Tax Board*, 463 U.S. 159 (1983), upheld the constitutionality of California's worldwide unitary method of income taxation as applied to a domestic parent corporation with foreign subsidiaries, the Court reserved judgment as to whether the constitutionality of the tax would be upheld as applied to a foreign controlled corporate group, the issue presented in these cases. Unlike the *Container*

Corporation case, the Federal Government has participated in this case to demonstrate that the application of the apportionment method used by California in these cases implicates foreign policy issues and prevents the Federal Government from speaking with one voice in this very sensitive area of foreign policy. Not only has the United States indicated to other nations the standard that should be used in apportioning income and not only have its foreign trading partners agreed to this standard, but its trading partners expect all political units of the United States to abide by this standard. Its major trading partners have protested the use of the unitary method of taxation to allocate income. California's insistence upon the use of that method has seriously complicated the Federal Government's economic relations with its major trading partners. In addition, the United Kingdom has enacted retaliatory legislation. The Court in *Container Corporation* opined that the most obvious foreign policy implications of a state tax is the retaliation by foreign governments against the United States. The *Container Corporation* court further noted that the nuances of foreign policy were much more the province of the Federal Executive than the Courts and that deference was due to its views. Neither retaliatory legislation nor the Federal Executive's views were presented in that case. There can be little doubt that the apportionment method used by California in the instant case is an impediment to the Federal Government's conduct of foreign relations and is thus unconstitutional.

The Appellant argues that the dormant Foreign Commerce Clause analysis, upon which the Federal Government, the Superior Court and the Court of Appeal have relied, is irrelevant because under the principles enunciated in *Wardair Canada v. Fla. Dept. of Revenue*, 477 U.S. 1 (1986), affirmative Congressional action has by implication allowed the states great freedom in the manner in which they impose income taxes including the freedom to employ the apportionment method in issue. In support of that position, the Appellant points to the fact that the Federal Government's tax policy with its trading partners in treaties or otherwise has dealt generally with federal taxation and that the Senate explicitly refused to approve the United States-United Kingdom Tax Convention until the clause barring the use of the worldwide apportionment method was removed from the treaty.

We are unaware that either the Congress or the Executive has ever given even tacit approval to the use of that method. Indeed, even with respect to the exclusion of the clause in the United States-United Kingdom Tax Convention forbidding this method of tax apportionment, the majority of the Senate favored eliminating that method. Thus, there is hardly any federal policy that eliminates the necessity of resorting to the dormant Foreign Commerce Clause analysis to test the Constitutionality of the apportionment method in issue.

We submit that for the reasons stated above, the judgment of the Court of Appeal should be affirmed.

ARGUMENT

THE COURT OF APPEAL CORRECTLY HELD THAT THE TAX IMPOSED ON THE TAXPAYERS IN THESE CASES WAS UNCONSTITUTIONAL BECAUSE ITS APPLICATION IMPLICATED UNITED STATES FOREIGN POLICY BY PREVENTING THE UNITED STATES FROM SPEAKING WITH ONE VOICE IN CARRYING OUT ITS COMMERCIAL RELATIONS WITH FOREIGN GOVERNMENTS

A. *Controlling legal principles.*

The power to regulate foreign commerce is reserved exclusively to the United States by the Foreign Commerce Clause of Article I, Section 8, Clause 3 of the United States Constitution. Further, it has been unequivocally established that the Federal Government, primarily through the Executive Branch, possesses the sole and exclusive authority to conduct and control the foreign affairs of the United States. *Chicago & Southern Air Lines, Inc. v. Waterman Steamship Corp.*, 333 U.S. 103, 111 (1948); *United States v. Pink*, 315 U.S. 203 (1942); *United States v. Belmont*, 301 U.S. 324 (1937); *United States v. Curtiss-Wright Export Corp.*, 299 U.S. 304, 314-316 (1936); *Oetjen v. Central Leather Co.*, 246 U.S. 297 (1918).

Under the Commerce and Due Process Clauses of the United States Constitution, a state may not impose a property or income

tax on tax values situated or earned outside its borders. *Container Corp. of America v. Franchise Tax Board*, 463 U.S. 159, 164 (1983), rehearing denied 464 909 (1983); *Asarco, Inc. v. Idaho State Tax Commission*, 458 U.S. 307, 315 (1982). However, within the ambit of interstate commerce it has been recognized that a state may constitutionally tax on an apportioned basis the total income and property of a corporation earning income in, and moving its property through, multiple taxing jurisdictions. *Container Corp. v. Franchise Tax Board, supra* at 164; *Exxon Corp. v. Department of Revenue of Wisconsin*, 447 U.S. 207 (1980); *Japan Line, Ltd. v. County of Los Angeles*, 441 U.S. 434, 444-445 (1979); *Mobil Oil Corp. v. Commissioner of Taxes of Vermont*, 445 U.S. 425 (1980); *Northwestern States Portland Cement Co. v. Minnesota*, 358 U.S. 450, 460 (1959). The test for constitutionality of a tax imposed on such an apportionment basis on property or income of a corporation engaged in interstate commerce is: (1) there must be a substantial nexus between the state and the activity or property taxed; (2) the activity or property must be fairly apportioned to the taxing state; (3) the tax must not discriminate against interstate commerce; and (4) the tax must be fairly related to the services provided by the state. *Wardair Canada, Inc. v. Florida Dept. of Revenue*, 477 U.S. 1, 8 (1986); *Japan Line, Ltd., supra* at 444-445; *Container Corp., supra* at 164.[12] *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274, 279 (1977).

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[12]The linchpin of apportionment in the field of state income taxation is the unitary business principle. *Mobil Oil Corp., supra.* The constitutional requirements set forth above as they pertain to the unitary business/formula apportionment method of taxation require that a state not tax a unitary business unless some part of it is conducted within the state, unless there is some minimal connection between interstate activities and the taxing state, and unless there is a rational relationship between the income attributable to the in-state corporation and intrastate values of the unitary enterprise. *Container Corp., supra* at 166; *Exxon Corp., supra* at 220; *Mobil Oil Corp., supra* at 436, 437; *Wisconsin v. J.C. Penney Co.*, 311 U.S. 435, 444 (1940). The second requirement above that the income or tax be fairly apportioned has two components: first, fairness requires internal consistency, so that if every state employs the formula the result would be that no more than all the

If the unitary business groups involved herein were only doing business in interstate commerce, the application of the unitary business concept and the apportionment formula method of taxation would not be unconstitutional. However, the plaintiffs are corporations which are members of a group controlled by a foreign parent corporation engaged in international commerce, and the above analysis of the Commerce Clause as it relates to interstate commerce is not identical to the analysis of that clause as it relates to foreign commerce. *Japan Line, Ltd., supra* at 446. The Commerce Clause as it relates to foreign commerce unequivocally reserves to the Federal Government exclusive power and jurisdiction to control and regulate foreign commerce. *Brolan v. United States*, 236 U.S. 216, 218-219 (1915). The Supreme Court in *Michelin Tire Corp. v. Wages, Tax Commissioner*, 423 U.S. 276, 285 (1976), clearly stated that state taxation cannot so impinge upon foreign policy considerations so as to prevent the United States from speaking with one voice when regulating commercial relations with foreign governments. The Supreme Court in *Japan Line, Ltd., supra* at 446-448, stated that when foreign commerce is present in a situation involving a state tax on an instrument of foreign commerce, two additional requirements are necessary for constitutionality: first, there must be no enhanced risk of multiple taxation; and second, the tax on the instrumentality of foreign commerce may not impair federal uniformity of policy where uniformity is essential. The focus of the second requirement is that the tax cannot prevent the Federal Government from speaking with one voice when regulating commercial relations with foreign governments. *Wardair Canada, Inc. v. Florida Dept. of Revenue*, 477 U.S. at 8; *Container Corporation of America v. Franchise Tax Board*, 463 U.S. at 185-197. The Court in *Japan Line, Ltd.*, 441 U.S. at 451, stated that "[i]f a state tax contravenes either of those precepts, it is unconstitutional under the Commerce Clause."

income of the unitary business would be taxed; and secondly, there must be external consistency such that the factors used in the apportionment formula reflect a reasonable sense of how the income is generated. *Container Corp.*, 463 U.S. at 169. These constitutional considerations also require that there be some bond of ownership or control uniting the purported unitary business. *Asarco, Inc., supra* at 316-317. In addition, the above principles have required that the out-of-state activities be related in some concrete way to the in-state activities; *i.e.*, that there be some sharing or exchange of value not capable of precise identification or measurement beyond the mere flow of funds arising out of passive investment. *Asarco, Inc., supra* at 317; *Mobil Oil Corp., supra* at 438-432. However, these requirements are not addressed in this brief.

Three recent Supreme Court decisions inform analysis for the resolution of the instant appeals. The first is *Japan Line, Ltd. v. County of Los Angeles, supra*. In that case, California imposed a nondiscriminatory, apportioned, ad valorem property tax on cargo containers that were instrumentalities of foreign commerce temporarily located in California ports. The containers were subjected to an unapportioned property tax in their country of domicile, Japan. The Court determined that the tax there in issue was unconstitutional because it resulted in multiple taxation of instrumentalities of foreign commerce and prevented the United States from speaking with one voice in the conduct of foreign affairs. 441 U.S. at 451-454.

With respect to the requirement that the taxation method used must not enhance the risk of multiple taxation, the Supreme Court in *Japan Line, Ltd., supra* at 446, 447, postulated certain preliminary principles. Multiple and duplicative taxation is offensive to the Commerce Clause. In order to prevent multiple and duplicative taxation states are required to impose taxes on instruments of domestic interstate commerce on an apportioned basis so that an instrumentality is subject to no more than one tax on the full value being taxed. In the interstate arena, the Court is able to enforce fair apportionment by all potential taxing jurisdictions in the United States. The Supreme Court stated that when foreign commerce is implicated in the imposition of an apportioned state tax (441 U.S. at 447-448 footnote omitted) —

> * * * neither this Court nor this Nation can ensure full apportionment when one of the taxing entities is a foreign sovereign. If an instrumentality of commerce is domiciled abroad, the country of domicile may have the right, consistently with the custom of nations, to impose a tax on its full value. If a State should seek to tax the same instrumentality on an apportioned basis, multiple taxation inevitably results.

> Hence, whereas the fact of apportionment in interstate commerce means that "multiple burdens logically cannot occur," *Washington Revenue Dept.*, 435 U.S. at 746-747, the same conclusion, as to foreign commerce, logically cannot be drawn. Due to the absence of an authoritative tribunal capable of ensuring that the aggregation of taxes is computed on no more than one full value, a state tax, even though "fairly apportioned" to reflect an instrumentality's presence within the State, may subject foreign commerce " 'to the risk of a double tax burden to which [domestic] commerce is not exposed, and which the commerce clause forbids.' " *Evco v. Jones*, 409 U.S. at 94, quoting *J.D. Adams Mfg. Co.*, 304 U.S. at 311.

With respect to the second requirement that a state tax may not impair federal uniformity of policy were uniformity is essential, the Court in the *Japan Line, Ltd.* case stated (441 U.S. at 448) that:

> Second, a state tax on the instrumentalities of foreign commerce may [not] impair federal uniformity in an area where federal uniformity is essential. Foreign commerce is preeminently a matter of national concern. "In international relations with respect to foreign intercourse and trade the people of the United States act through a single government with unified and adequate national power." *Board of Trustees v. United States*, 289 U.S. 48, 59 (1933).

The second case is *Container Corp. of America v. Franchise Tax Board, supra*, in which the Court analyzed the constitutionality of California's use of the worldwide unitary method of taxation in taxing the income of a domestic corporation, which, with its subsidiaries, did business in the United States and in foreign countries. The Court therein first analyzed the tax in question pursuant to the requirements for constitutionality of a corporate group engaged only in domestic interstate commerce, and found California's tax to be constitutionally permissible under those standards. *Container Corp., supra* at 185. Since the unitary group of corporations was doing business in foreign nations as well as in California, the Court found it necessary to examine the constitutionality of the tax in question under the two additional tests

formulated in *Japan Line* for testing the constitutionality of a state tax on an instrument or entity engaged in foreign commerce, *i.e.*, whether the tax involved an enhanced risk of double taxation, and whether the tax impaired the United States' ability to speak with one voice in an area of foreign commercial relationships where federal uniformity is necessary.

With respect to the first requirement posited in *Japan Line* under the dormant Foreign Commerce Clause, the Supreme Court in *Container Corp.* found that application of the unitary apportionment formula in taxing the income of the subsidiary of a domestic parent with foreign subsidiaries did not entail an enhanced risk of double taxation. The Court in *Container Corp.* concluded on the evidence before it that the "arm's length" method of taxation also entailed risks of double taxation in the field of foreign commerce; and since risks of double taxation were unavoidable under both alternatives, and could only be avoided by the state not taxing the group's income at all (which was unacceptable since some of the group's income was sourced in the state), application of the unitary business concept and apportionment formula was not unconstitutional by virtue of the unavoidable possibilities of double taxation. *Container Corp., supra* at 189-193. The courts below on the basis of this reasoning in *Container Corp.*, found that there was no enhanced risk of double taxation with respect to the tax imposed herein. (Slip Opinion, pp. 30-31; CT. 1750.)[13]

Next the Supreme Court in *Container Corp.* elaborated at length on the second requirement it established in *Japan Line*, to determine the constitutionality of a state tax applied to an

[13]We do not address this conclusion of the courts below. This brief emphasizes the invalidity of the application of the tax in question because the tax prevents the Federal Government from speaking with one voice in the conduct of foreign affairs and international trade. This emphasis on the second requirement in *Container Corp.* is not a concession that California's tax does not enhance the risk of double taxation, but rather is a recognition that this tax is an egregious interference with the Federal Executive's conduct of foreign affairs and is thus, patently unconstitutional.

instrumentality of foreign commerce. The Court stated (463 U.S. at 186, 194 (footnote omitted)):

> "A state tax on instrumentalities of foreign commerce may frustrate the achievement of federal uniformity in several ways. If the State imposes an apportioned tax, international disputes over reconciling apportionment formulae may arise. If a novel state tax creates an asymmetry in the international tax structure, foreign nations disadvantaged by the levy may retaliate against American-owned instrumentalities present in their jurisdictions..... If other States followed the taxing State's example, various instrumentalities of commerce could be subjected to varying degrees of multiple taxation, a result that would plainly prevent this Nation from 'speaking with one voice' in regulating foreign Commerce." [quoting *Japan Line, Ltd., supra* at 448.)
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> In conducting this inquiry, however, we must keep in mind that if a state tax merely has foreign resonances, but does not implicate foreign affairs, we cannot infer "[a]bsent some explicit directive from Congress, ... that treatment of foreign income at the federal level mandates identical treatment by the States." *Mobil,* 445 U.S. at 448. See also *Japan Line,* 441 U.S. at 456, n.20; *Michelin Tire Corp., supra,* at 286. Thus, a state tax at variance with federal policy will violate the "one voice" standard if it *either* implicates foreign policy issues which must be left to the Federal Government *or* violates a clear federal directive. The second of these considerations is, of course, essentially a species of preemption analysis.

Next the Supreme Court stated (463 U.S. at 194, 195-196):

> The most obvious foreign policy implication of a state tax is the threat it might pose of offending our foreign trading partners and leading them to retaliate against the Nation as a whole. 441 U.S. at 450. In considering this issue, however, we are faced with a distinct problem. This Court has little competence in determining precisely when foreign nations will be offended by particular acts, and even less competence

> in deciding how to balance a particular risk of retaliation against the sovereign right of the United States as a whole to let the States tax as they please.
>
> * * * *
>
> A state tax may, of course, have foreign policy implications other than a threat of retaliation. We note, however, that in this case, unlike *Japan Line,* the Executive Branch has decided not to file an *amicus curiae* brief in opposition to the state tax. The lack of such a submission is by no means dispositive. Nevertheless, when combined with all the other considerations we have discussed, it does suggest that the foreign policy of the United States — whose nuances we must emphasize again, are much more the province of the Executive Branch and Congress than of this Court — is not seriously threatened by California's decision to apply the unitary business concept and formula apportionment in calculating appellant's taxable income.

Having found this tax as applied in *Container Corp.* not to enhance the risk of double taxation, and further not to implicate foreign policy issues, the Supreme Court upheld the tax in question. However, the Supreme Court in *Container Corp.* expressly reserved judgment as to whether the constitutionality of the tax would be upheld as applied to a foreign controlled corporate group, the issue presented in this case. *Container Corp., supra* at 189, n.26, and 195 n.32.

The third case germane to the instant controversy is *Wardair Canada, Inc. v. Florida Department of Revenue,* 477 U.S. 1 (1986). In that case the State of Florida's sales taxation of all fuel purchased in Florida was challenged by a Canadian airline operating charter flights to and from the United States. The airline attacked the validity of Florida's tax statute insofar as it authorized assessment of a tax on fuel used by foreign airlines engaged exclusively in foreign commerce. The airline argued: that by the Federal Aviation Act Congress preempted the field of foreign air travel and thus left no room for local government taxation of such travel; that the tax violated the Foreign Commerce Clause of the United States Constitution and a federal policy expressed in the

Convention on International Civil Aviation of 1944 (Chicago Convention) to which Canada, the United States, and 155 other nations were parties; and that the tax was inconsistent with the Nonscheduled Air Services Agreement between the United States and Canada regulating air charter service between the United States and Canada.

The Supreme Court in *Wardair* first analyzed the preemption argument and noted that Congress through the Federal Aviation Act had regulated aviation extensively. But the Supreme Court held that state law is not automatically preempted wherever there is a federal regulation of an activity, an industry or an area of the law. The Court noted that when Congress legislates within the scope of its constitutionally granted powers, that legislation may displace state law. Whether or not there is such a preemption depends upon whether Congress intended to displace state law. If there is an actual conflict between state law and federal law then it is presumed that Congress intended preemption. Where there is no actual conflict between federal and state law, the Supreme Court has required evidence of a congressional intent to preempt the field. *Wardair Canada, Inc., supra* at 6. In *Wardair* the Supreme Court found that not only was there a lack of evidence of an intent to preempt the field but to the contrary, the Federal Aviation Act expressly permitted state sales taxation of purchases of airline fuel. Thus, there was no preemption in the carrier's favor. (477 U.S. at 7.)

With respect to the Foreign Commerce Clause argument, the Supreme Court likewise held the state tax valid. The Supreme Court first recognized that in cases where the Federal Government had not acted, it is the responsibility of the judiciary to strike down action taken by state or local authorities that unduly threatens the values protected by the Commerce Clause. *(Ibid.)* The parties in *Wardair* claimed the tax in question impaired the ability of the United States to speak with one voice in the field of foreign relations.

The Court in *Wardair* noted a special need in the area of foreign commerce for federal uniformity, citing *Board of Trustees v. United States*, 289 U.S. 48, 59 (1933), and *Japan Line, Ltd. v. County of Los Angeles, supra*. The Court stated that "In international relations and with respect to foreign intercourse and trade the people of the United States act through a single government with unified and adequate national power." *Wardair Canada, Inc., supra* at 8. The Supreme Court in *Wardair* then reiterated the two additional requirements for testing the validity of a state tax affecting foreign commerce as posited in *Japan Line, Ltd.* to wit: whether the state tax enhances the risk of international multiple taxation; and whether the tax impairs the Federal Government from speaking with one voice when regulating commercial relations with foreign governments. (477 U.S. at 8.) In *Wardair* it was admitted that there was no threat of multiple taxation as the Florida tax was imposed solely upon the sale within the state of airline fuel. Rather the carriers contended that the tax was invalid because there existed a federal policy of reciprocal tax exemptions for the instrumentalities of international air traffic, including aviation fuel, and that this policy represents the statement that the "one voice" of the Federal Government wished to make, and this "one voice" statement was threatened by the state tax in question (*Id.* at 9.)

The Supreme Court in *Wardair* held that the various conventions and agreements cited by the parties did not evidence any such federal policy as contended by the parties but rather showed that the Federal Government had accepted and allowed state taxation of fuel purchased within the taxing states' borders. Further, the affirmative action by the Federal Government in these conventions and agreements in allowing such state taxation removed this case from the context of a dormant Foreign Commerce Clause situation in which the Federal Government had remained silent and had allowed the states to act in this area without any need for uniformity. (*Id.* at 9.) In short, rather than preempting the field in favor of the carrier, the Congress by affirmatively allowing state taxation of aviation fuel in the Chicago Convention and in the more than 70 bilateral agreements governing international aviation to which the United States was a party, had affirmatively decided to permit such state taxation. The Supreme Court in *Wardair* concluded that there was no silence on the issue which would trigger a dormant Foreign Commerce Clause analysis and there was no announced federal policy on the issue which the Florida tax contravened. Accordingly, the Florida

sales tax on aviation fuel as levied on foreign aviation carriers was upheld by the Supreme court in *Wardair*.

It is submitted that under the foregoing rationales of the Supreme Court's decisions in *Japan Line, Ltd., Container Corp.*, and *Wardair*, California's application of its worldwide unitary apportionment formula method of computing income tax is unconstitutional as applied to a unitary group of corporations controlled by a foreign parent corporation. Such an application impairs the ability of the United States to speak with one voice in the conduct of foreign commercial relations in an area where federal uniformity is necessary. Application of this tax has disrupted the foreign relations of the United States as conducted by the Federal Executive and has given rise to retaliatory legislation by one foreign nation.

B. *Under the controlling constitutional principles the instant tax as applied to the taxpayers is unconstitutional.*

The Federal Government is responsible for the formulation and implementation of the foreign policy of the United States. State statutes or practices conflicting with or impeding the Federal Government's responsibilities with respect to the foreign relations of the United States are void under the Federal Constitution.

The trial and appellate courts below, citing *Container Corp.* concluded that Congress had not enacted any statute either favoring or opposing income taxation by states of foreign nationals through application of the worldwide unitary business concept and three-factor apportionment formula. (Slip Opinion, pp. 17, 21-30; CT. 1740, 1758.)[14] Thus the courts below properly found

[14]The Court of Appeal and the trial court noted that the Federal Executive had negotiated in the 1975 United States-United Kingdom Tax Treaty a clause (Clause 9(4)) proscribing a state's use of the worldwide unitary business concept and three-factor formula in computing a foreign corporation income tax; and that this clause was inserted at the instance of the United Kingdom as a result of California's extension of the said method of income tax computation to foreign nationals. The Senate Foreign Relations Committee defeated in committee a reservation with respect to Clause 9(4) by a vote of 10 to 5. On the Senate floor

that there was no direct conflict between the state tax as applied and any federal statute or Congressional policy, hence there was no issue of preemption. (Slip Opinion, pp. 17, 21-30; CT. 1745.) Accordingly, the courts below proceeded to apply a dormant Foreign Commerce Clause Analysis to the facts of this case.

The Court of Appeal and the trial court correctly found the Federal Executive to have taken the position that California's method of computing the income tax of a member of a unitary business group owned by a foreign parent corporation should be discontinued as contrary to internationally accepted accounting standards (Slip Opinion, pp. 34, 45, 52; CT. 1741) and the international practice favoring the arm's length method of tax computation (Slip Opinion, p. 54; CT. 1749). The application of California's method of taxation in computing the tax of the taxpayers involved in this case is unconstitutional under the Foreign Commerce Clause as an impermissible interference with the Federal Government's policy and conduct of foreign relations.

The adoption by the Federal Executive of this policy is evidenced by the letter of January 30, 1986, from the Secretary of State for the United States to the Governor of California, wherein the Federal Executive advises that in the conduct of foreign affairs it has taken "the position that the 'arm's length' adjustment method of allocating income among commonly controlled corporations doing business in various national jurisdictions is the appropriate method to be employed." (Letter.) The letter further states that this view is reflected in the bilateral tax treaties to which the United States is a party. Those tax treaties provide that income attributable to "permanent establishment" in the territory

the reservation was again defeated by a vote of 46 to 34; thereafter the treaty received a favorable vote of 49 to 32, five votes short of the ⅔ vote required for advice and consent to ratification. Subsequently Clause 9(4) was reserved to without a vote and the treaty was approved with the reservation. The courts below held that these three votes favoring Clause 9(4) (one in committee and two on the Senate floor) did not evidence a Congressional policy for California's method of taxation but rather, if anything, a Congressional preference, not amounting to a policy, favoring discontinuance of California's method of taxation. (Slip Opinion, pp. 28-29; CT. 1739-1740.)

of a party will be taxed by that party on the basis of the arm's length method of apportionment. (See footnote 5, *supra.*)[15] The Internal Revenue Code also adopts this apportionment method. Moreover, this letter from the Secretary of State clearly expresses the position taken by the Federal Executive that the arm's length apportionment method is the "international standard" and "international rule" which has been adopted generally by foreign tax systems, and is prescribed in the model income tax treaties published by the Organization for Economic Cooperation and Development (OECD) and the United Nations. (Letter.) Article II of the Constitution vests the power to conduct and control the foreign affairs of the United States solely with the President of the United States and his duly appointed aides; and the Executive has the particular expertise needed to identify and assess which rules and practices are generally accepted and followed by the international community and which are not. Its determinations in such regard are entitled to very great weight by the courts. *Container Corp.*, 463 U.S. at 195. See also *Factor v. Laubenheimer*, 290 U.S. 276, 295 (1933); *Charlton v. Kelley*, 229 U.S. 447, 468 (1913).

It is the position of the United States Government, as reflected in the letter of the Secretary of State to the Governor of California, that the unitary tax is at odds with the "arm's length" accounting method which is the international rule and standard, and that adherence to the "arm's length" method of taxing corporations with foreign parents is essential to avoid adverse consequences for the foreign relations of the United States. (Letter.) Under these circumstances, state tax methods which contravene this position cannot be reconciled with the Foreign Commerce Clause of the United States Constitution. The conflict between this position adopted by the United States in the conduct

[15]Contrary to the Appellant's argument (Br. 32, n.23), there is nothing in the recent treaties departing from the arm's length method. Indeed, Article 9(3) of the Income Tax Treaty with Barbados, December 31, 1984, T.I.S.A. No. 11090, was added to make it clear that the United States retained the right to apply its inter-company pricing rules, which apply the arm's length standard. (Code Sec. 482 (of the arm's length standard)). S. Exec. Rept. 99-9, 99th Cong. 1st Sess. at 25.

of foreign relations and the California tax as applied in the instant case to taxpayers with foreign parents must, therefore, be resolved in favor of the position taken by the United States.

This conflict is precisely the type of state action which the Supreme Court in *Container Corp., supra*, found would be unconstitutional in that it prevents the Federal Government from speaking with one voice in foreign relations. Moreover, this conflict is substantial in nature, as is evidenced by the Secretary of State's letter to the Governor of California to the effect that state worldwide unitary taxes have become a source of conflict with numerous foreign governments, including those of Australia, Belgium, Canada, Denmark, France, the Federal Republic of Germany, the United Kingdom, Greece, Ireland, Italy, Japan, Luxembourg, the Netherlands and Switzerland. (Letter.) The Secretary of State concluded in his letter to Governor Deukmejian (Letter at 2) that:

> Continued state taxation on a worldwide unitary basis will greatly impair the ability of the federal government to carry out its tax and investment policy in the international arena and to manage the sensitive issue of international double taxation. The worldwide unitary issue has seriously complicated our economic relations with many of our closest allies.

Further, the conflict has resulted in the United Kingdom's enactment of retaliatory legislation. (Letter.) The Supreme Court in *Container Corp.* pointed out 463 U.S. at 194, that the most obvious interference with foreign affairs which a state tax statute could pose was offending foreign trading partners to such an extent that they might enact retaliatory legislation against the United States as a whole, but that there was no such retaliatory legislation demonstrated in *Container Corp.* The Supreme Court in *Container Corp.* stated that it had little competence in determining precisely when foreign nations will be offended by particular acts and how to balance the risk of such retaliation against the sovereign right of the United States as a whole to allow states to tax as they please. *Container Corp., supra* at 194. The letter from Secretary Schultz to Governor Deukmejian cites the United Kingdom's retaliatory legislation as one of the difficulties California's taxing method has precipitated in the conduct of foreign

affairs. (Letter at 3.) This is precisely the type of impediment to the conduct of foreign affairs which *Container Corp.* indicated would render a state tax unconstitutional. 463 U.S. at 194.

The Supreme Court further pointed out, in *Container Corp.*, 463 U.S. at 195, that a state tax could have foreign policy implications other than retaliatory legislation, but that the nuances of foreign policy are much more the province of the Federal Executive than the Supreme Court. Since the Federal Executive did not elect to file an *amicus curiae* brief in *Container Corp.*, the Supreme Court assumed that there were no substantial foreign policy considerations which the state tax in that case contravened. Therefore, it upheld the application of the tax in question there to a domestic corporation with foreign subsidiaries. *Container Corp. v. Franchise Tax Board*, 463 U.S. at 195-196.[16] *Container Corp.* involved the application of California's tax to a domestically controlled group of corporations and it was that issue on which

[16]The trial court below also held California's tax as applied to be unconstitutional as it discriminated against instruments of foreign commerce (CT. 1751-1754) and violated the Due Process Clause (CT. 1754-1756). The trial court found that each foreign nation has its own version of "generally accepted accounting principles" (GAAP), and that a foreign corporation using its own national version of GAAP is able to file an "arm's length" tax return with its own country and with the United States without any inordinate additional expenses. (CT. 1752.) However, a foreign corporation using its national version of GAAP would have to incur an inordinate expense to comply with California's income tax method involved herein. (CT. 1752, 1753.) The trial court found this inordinate expense to discriminate against foreign corporations. (CT 1753.) As an alternative to this inordinate expense the foreign corporation could seek advance rulings from the California Franchise Tax Board or could seek the Board's approval to use estimates instead of actual accounting entries. However, the trial court held that advance rulings and use of estimates was entirely at the discretion of the taxing authorities and such total discretion was a lack of due process. (CT. R. 1754-1756.) The Court of Appeal did not reach this issue as it deemed it unnecessary. (Slip Opinion, pp. 54-55.) We submit that this discriminatory treatment and lack of due process is but another facet of California's tax as applied herein which has exacerbated the Federal Executive's problems in dealing with foreign nations in this area.

the Federal Executive expressed no view. The Supreme Court in *Container Corp.*, as stated before, expressly reserved judgment on the issue in the instant case. To allay any doubts as to the Federal Executive's position on the issue herein, this *amicus* brief is being filed. Thus, this Court should have no difficulty in determining the Federal Executive's views. The statements of the Secretary of State (Letter) and of the President of the United States (Statement) demonstrate that the Federal Government has a clearly articulated policy in favor of "arm's length" accounting in the conduct of foreign affairs, and that California's worldwide combined unitary business method is in conflict with the internationally accepted standard and policies, and custom, and has caused serious disputes and difficulties for the United States in the conduct of foreign affairs. Because of these foreign policy considerations and because of their gravity, the Department of Justice, at the direction of the President, is filing this *amicus curiae* brief.

C. *Appellant's argument*

The Appellant argues (Br. 20-27) that under the rationale of *Wardair* there in affirmative Congressional action allowing California to utilize its apportionment formula in computing appellees' tax liabilities, and that this Congressional action and policy obviates the need for any dormant Foreign Commerce Clause analysis. The Appellant argues (Br. 22) that *Wardair* permitted negative implications to be drawn that the state tax in *Wardair* was permissible under federal law in two circumstances: (1) when there was a treaty restricting the national governments' abilities to tax but not restricting the subnational governments; and (2) when there were treaties restricting the power of subnational governments to enact some taxes but not restricting their power to enact other taxes. (Appellant Br. 22.) The Appellant points to the various bilateral tax treaties between the United States and foreign countries as examples of treaties restricting national governments but not subnational governments, and derives therefrom a negative inference that states are authorized by federal law to impose taxes such as the one at issue. (App. Br. 22-24.) Appellant cites the non-discrimination tax clause made applicable to the states in some of the United States' tax treaties as examples of treaties which restrict some state tax powers, but not other

state tax powers, and thus form a basis for implying that the non-banned powers are authorized as a matter of federal law. (App. Br. 26-27.) Appellant concludes that the negative implications to be drawn from the above described treaties amounts to a clear federal congressional decision authorizing the state tax method in issue, and thus, under *Wardair* negates any dormant Foreign Commerce Clause analysis under *Container Corp.* (App. Br. 20-27.)

The Court of Appeal (Slip. Op. pp. 22-30) correctly pointed out that *Wardair* provides no support for Appellant's argument. *Wardair* involved a situation wherein the plaintiff, a Canadian company engaged only in foreign commerce, claimed that Florida's imposition of a sales tax on aviation fuel purchased by the carrier in Florida was unconstitutional under the Foreign Commerce Clause as it impaired the United States' ability to speak with one voice in the conduct of foreign affairs. The Supreme Court in *Wardair*, however, decided the case against the taxpayer finding that there was an affirmative federal policy allowing such taxation. This finding was based upon the Chicago Convention, the Federal Aviation Act, and more than 70 bilateral agreements on aviation to which the United States was a party. In 1944 the United States and 156 other nations, including Canada, became signatories to the Chicago Convention. *Wardair Canada*, 477 U.S. at 10. This convention expressly addressed the sales and use tax problem on aviation fuel, and explicitly prohibited only the imposition of such taxes with respect to fuel on board a foreign carrier when it entered the taxing jurisdiction. *Ibid.* at 10. The necessary negative implication of this provision was that other local sales and use taxes on aviation fuel were not prohibited. *Ibid.* at 10. The Supreme Court in *Wardair* also pointed out that Section 1113 of the Federal Aviation Act addresses the problem of state taxation of air commerce expressly forbidding some state taxes and expressly allowing certain state taxes. *Id.* at 6. Among the permissible taxes under that statute are state sales and use taxes. *Id.* at 7. Next the Supreme Court in *Wardair* noted that after the Chicago Convention addressed the state sales tax issue in 1944, the United States entered into more than 70 bilateral aviation agreements, most of which explicitly prohibited national taxes on aviation fuel used by carriers of the other contracting

party, but none of which interdicted state taxes on such fuel. *Id.* at 11. The Supreme Court in *Wardair* held that the Chicago Convention demonstrated the United States' and the international community's awareness in 1944 of the state and local sale taxation problem with respect to aviation fuel, and the provisions of that convention represented a decision by the parties to the convention to address the problem by curtailing and limiting only some of the local taxing authorities' power to tax, thereby preserving other aspects of that local power to tax. *Id.* at 10. Further, the Supreme Court found that in the 70 bilateral aviation agreements entered into since the Chicago Convention, the United States was aware of the sales tax problem, knew of the Chicago Convention's treatment of the problem, and elected not to change that treatment but knowingly acquiesced in state sales taxation of aviation fuel. *Id.* at 12.

The Supreme Court held these knowing acts formed an affirmative decision and policy by the United States to allow sales taxation of aviation fuel. Accordingly, the Supreme Court found that the United States' position was in accord with Florida's and there was no need to resort to any dormant Foreign Commerce Clause Analysis to see if the tax in question was unconstitutional. *Id.* at 9, 13.

In advancing its argument that a dormant Foreign Commerce Clause analysis is not warranted, the Appellant contends that prior to the ratification of the United States-United Kingdom tax convention in 1978 there were numerous United States tax conventions which did not prohibit the taxation method employed herein. In finding a federal policy favoring the tax there involved, the Appellant equates these tax conventions with the 70 bilateral aviation agreements that the Supreme Court noted in *Wardair*. As the Court of Appeal correctly pointed out (Slip. Opinion, pp. 25-26), Appellant's argument overlooks one significant difference between the 70 bilateral agreements involved in *Wardair* and the tax conventions it cites here which were ratified before 1978. Although both sets of agreements are silent as to the respective state taxation involved, the 70 bilateral agreements involved in *Wardair* were entered into after the Chicago Convention had addressed specific local taxes that were precluded. There are no

foundation agreements dealing with the instant issue of state taxation to which the tax treaties can be related. Thus, as the Court of Appeals recognized (*Ibid.*), no negative inference can be drawn supporting the tax method in issue from the fact that the various United States bilateral tax treaties did not purport to restrict state taxing power. None of those treaties, except for the United States-United Kingdom, mentions the unitary tax method. Equally inapposite are the nondiscrimination clauses of the treaties of Friendship, Commerce, and Navigation because the subject matter of such clauses is so dissimilar to clauses authorizing or prohibiting a particular type of tax or tax method as were present in *Wardair.*

Moreover, as the courts below pointed out (Slip Opinion, pp. 23-24; CT. 1738), the unitary method of taxation was never a serious factor in foreign affairs until it was first applied to foreign controlled multinational corporations in 1972. Indeed, the trial court concluded that one could not realistically determine any such reaction or policy position until Appellant's expanded use of the unitary method of taxing foreign multinational corporations was felt through audits, assessments, protests and negotiations between the United States and foreign governments. (CT. 1738.) Thus, as the courts below concluded (Slip Opinion, pp. 23-24; CT. 1739, 1758-1759), the numerous tax and Commerce, Navigation and Friendship conventions in force as of 1978, which do not address the taxation issue here presented, and of which the treaty parties were not seriously concerned, are of no significance as the 70 treaties were in *Wardair.*

A further ground for rejecting the Appellant's argument that there exists a federal policy allowing the method of taxation here and thus no dormant Foreign Commerce Clause analysis is warranted, is the fact that the Supreme Court, in considering in *Container Corp.* the identical method of taxation involved herein as applied to a domestically controlled and owned unitary group of corporations doing business domestically and overseas, examined the constitutionality of the tax there in issue using a dormant Foreign Commerce Clause analysis. *Container Corp. v. Franchise Tax Board,* 463 U.S. at 185-196. If the Supreme Court in *Container Corp.* had found a Congressional policy favoring

unitary taxation of domestically owned multicorporate groups doing business overseas, that would have ended the inquiry and there would have been no need to engage in a dormant Foreign Commerce Clause analysis. But the Supreme Court expressly found no such policies and thus resorted to the dormant Foreign Commerce Clause analysis. *Container Corp. v. Franchise Tax Board,* 436 U.S. at 196. The courts below correctly interpreted *Container Corp.* as holding there is no Congressional policy either for or against such method of income taxation. (Slip Opinion, pp. 29-30; CT. 1758.)

Another ground advanced by Appellant for the existence of a federal policy permitting the tax method in issue is the fact that the Senate in 1978 approved the United States-United Kingdom Tax Convention with a reservation negating language contained in Clause 9(4) which would have barred California's tax in this case. (Appellant Br. 14-16, 25.) Both the Court of Appeal and the trial court below specifically addressed this argument and correctly found it without merit. (Slip Opinion, pp. 28-29; CT. 1739-1740.) The trial court noted that the Federal Executive had inserted Clause 9(4) in the proposed United States-United Kingdom tax convention at the insistence of the United Kingdom and that Clause 9(4) would have barred the application of the instant tax. (CT. 1739.) However, the Court of Appeal and the trial court pointed out that when a reservation to Clause 9(4) was introduced in hearings before the Senate Finance Committee on the proposed tax convention, the Committee defeated the reservation by a vote of 10 to 5; next on the Senate floor this reservation to Clause 9(4) was defeated by a vote of 44 to 34. (Slip Opinion, p. 289; CT. 1739.) On this basis the proposed tax convention was submitted to the Senate for a vote for ratification and the Senate voted 49 to 32 for ratification, 5 votes short of the ⅔ vote necessary for ratification. (Slip Opinion, p. 28.) Next the Senate reserved Clause 9(4) without a vote and the tax convention was approved with the reservation. The Court of Appeal and the trial court in their opinions expressly noted that the reservation to Clause 9(4) received a minority of votes in each of 3 votes: the vote in committee and the votes on the floor of the Senate. (Slip Opinion, p. 28; CT. 1739.) Accordingly, the courts below held that this vote represented not a vote for a policy favoring the

allowance of states to impose the worldwide combined unitary business method of income taxation, but rather represented a preference, not amounting to a policy, against such a method of income taxation. (Slip Opinion, p. 29; CT. 1740.) The Court of Appeal stated that it failed to see how three majority votes in the Senate essentially approving Clause 9(4) could be transmogrified into a Congressional of disapproval of Clause 9(4) and approval of the tax method in issue. (Slip Opinion, p. 29.) In any event, in these special circumstances of treaty making does not establish federal policy in favor of such state taxation methods. Therefore, the Court of Appeal and the trial court rejected this argument and so should this Court.[17]

In view of the foregoing it is submitted that the Court of Appeal correctly concluded that there was no affirmative federal policy permitting California's use of the tax method in issue, and that therefore the issues herein should be resolved by a dormant Foreign Commerce Clause analysis as stated in *Container Corp.* (Slip Opinion, pp. 24-30).

The Appellant argues that the Court of Appeal erred when it found that the United States Executive could be the "one voice" which established a federal policy prohibiting the tax method at issue, rather than the voice of Congress. (Appellant Br. 28-32.) Appellant maintains that the Executive cannot exercise the "one voice" in foreign affairs but only Congress can. (Appellant Br. 29). From this Appellant concludes that the Court of Appeal erred in its dormant Foreign Commerce Clause analysis by considering the Executive's actions as the United States "one voice" speaking in the conduct of foreign affairs. (Appellant Br. 29.) No statutory or case law authority is offered for this argument, and it completely ignores the long and clearly established rule that the Executive Branch conducts the foreign affairs of the United States, and if Congress has not acted in this area, actions of the Executive are the acts of the United States and represent United States' policy until Congress acts to the con-

[17]It is absurd to conclude, as does the Appellant, that three losing minority votes in the Senate against the reservation of Clause 9(4) could be the basis of a policy position of the whole Senate.

trary. *Chicago & Southern Air Lines, Inc. v. Waterman Steamship Corp., supra; United States v. Pink, supra; United States v. Belmont, supra; United States v. Curtiss-Wright Export Corp., supra; Oetjen v. Central Leather Co., supra,* see also: *Dames & Moore v. Regan,* 453 U.S. 654 at 678-684 (1981).

Appellants also argue (Br. 28-29) that the Court of Appeal erred in its dormant Foreign Commerce Clause analysis by looking to the Executive Branch for a federal directive and policy. Appellants lose sight of why the Court of Appeal looked to federal policy as expounded by the Executive Branch. That Court followed faithfully the directions of the Supreme Court in *Container Corp.*, which mandates that state taxing practices must give way if they intruded into the conduct of the foreign relations of the United States and interfered with the conduct of foreign affairs. The Court of Appeal specifically found that the tax method in question was in conflict with the norms and standards of international commerce, had offended numerous foreign countries, caused a number of disputes and problems in the United States' conduct of foreign affairs, and had led to retaliatory legislation by the United Kingdom. (Slip Opinion, pp. 32-34.)[18] The Court of Appeal then concluded (Slip, Opinion, pp. 42-45) that the Federal Executive had exercised its lawful powers in the conduct of foreign affairs in this area in order to eliminate disputes with its trading partners and that contrary state law must give way to the

[18]Appellant also argues that the conduct of foreign affairs is not significantly implicated because the retaliation by Great Britain is not justified under United States law. It is submitted that the conduct of foreign affairs is necessarily determined not by whether a foreign country's actions are justified under our law as opposed to foreign law but rather whether there is a dispute with a foreign country and what is the most efficient and beneficial manner of resolving that dispute. Accordingly, whether or not Great Britain's retaliatory legislation is or is not justified under our law is of no great moment. The fact remains that a potentially serious dispute exists with Great Britain, and retaliatory legislation by Great Britain is in place, both of which can have adverse effects on the United States' foreign commercial relations. This alone is a serious matter in the conduct of the United States' foreign affairs which must be addressed by the Federal Executive.

"One Voice" requirement of the dormant Foreign Commerce Clause Analysis. When California frustrates this "one voice" of the federal government speaking in the conduct of foreign affairs, the Foreign Commerce Clause of the United States Constitution is infringed.

CONCLUSION

For the reasons stated above, the decision below is correct and should be affirmed on the ground that the method of taxation involved is unconstitutional as it impairs the United States' ability to speak with one voice in an area where federal uniformity is essential.

Respectfully submitted,

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APPENDIX A

THE SECRETARY OF STATE
WASHINGTON

January 30, 1986

Dear Governor Deukmejian:

As you are aware, federal legislation was recently introduced with the full support of the Administration which would prohibit states from taxing corporations under the worldwide unitary method and from taxing more than an equitable share of foreign source dividends. This action was taken at the express direction of the President. I am writing to explain to you the foreign policy concerns that prompted this legislation and to urge you to act promptly to reconsider your state's use of the worldwide unitary method of taxation.

When a corporation (or related group of corporations) operates across state or national boundaries, competing tax claims of the jurisdictions in which the corporate group operates are resolved by identifying the income attributable to each jurisdiction. Two different methods are in use for making the determination with respect to transnational income: separate accounting and worldwide unitary combination. The longstanding policy of the federal government has been to follow the separate accounting method. The United States has advocated and adopted the position that the "arm's-length" adjustment method of allocating income among commonly controlled corporations doing business in various national jurisdictions is the appropriate method to be employed. This view is embodied in the Internal Revenue Code and is a central feature in our bilateral tax treaties. Separate accounting is also the international standard. It is prescribed in the model income tax treaties published by the Organization for Economic Cooperation and Development ("OECD") and the United Nations ("UN") and by foreign country tax systems

generally. In contrast, the worldwide unitary method of taxation is followed only by seven of the U.S. states. Your state's employment of the worldwide unitary method of tax accounting is at odds with the position of the United States and has become a source of conflict with foreign states.

In an environment in which separate accounting is the federal policy and the generally accepted international rule, state taxation on a worldwide unitary basis creates a clear risk of double taxation. Because labor costs and property values vary sharply on an international basis, the rates of profitability of affiliates operating within and without the jurisdiction of the unitary state are often different. Double taxation will result if the relative profitability of the investment in the unitary tax state is less than that of the affiliated overseas operations that are taxed abroad on a separate accounting basis. This risk of double taxation may distort investment decisions, thereby reducing the overall flow of investment into the United States.

Our concern over the worldwide unitary method of taxation's inhibiting effect on foreign investment in the United States is shared by many foreign governments. They have advised us of their view that "The [unitary tax] method can chill international investment and decrease efficient allocation of resources and employment opportunities. In particular, the unitary method can impede foreign entry into the United States market." They contend that the unitary method of taxation constitutes "... a serious obstacle to the further development of our trade and investment relationships." (Diplomatic note signed by the Ambassadors of Australia, Belgium, Canada, Denmark, France, Federal Republic of Germany, the United Kingdom, Greece, Ireland, Italy, Japan, Luxembourg, the Netherlands, and Switzerland.)

The administration of the worldwide unitary method of taxation also imposes unreasonable and costly compliance burdens on an enterprise which is considered to be part of a worldwide unitary group. The information required by the tax authorities of the jurisdiction practicing a worldwide unitary method of taxation may not be readily available to the enterprise and, in the case of foreign-controlled entities which are not required to keep data under U.S. tax and financial accounting rules on their non-U.S.

operations for any other reason, will require costly conversion into a form usable by the jurisdiction's tax authority.

For these reasons I believe state worldwide unitary taxation to be inappropriate. Continued state taxation on a worldwide unitary basis will greatly impair the ability of the federal government to carry out its tax and investment policy in the international arena and to manage the sensitive issue of international double taxation. The worldwide unitary issue has seriously complicated our economic relations with many of our closest allies. During my tenure as Secretary of State, this has been a difficult and long-lasting issue. The Department of State has received diplomatic notes complaining about state use of the worldwide unitary method of taxation from virtually every developed country in the world. The unitary issue has been partially responsible for stalling some bilateral tax treaty negotiations.

Most seriously, the U.K. Parliament, in July, 1985, unanimously adopted anti-unitary retaliatory legislation permitting the U.K. government to deny, on a unilateral basis and retroactive to April, 1985, a very valuable benefit of the U.S.-U.K. tax treaty for U.S. corporations operating in worldwide unitary states. This legislation, by virtue of a provision which makes possible the retroactive imposition of heavy penalties, was having a chilling effect on the willingness of U.S. companies to repatriate earnings of their U.K. subsidiaries to the United States and on their willingness to claim benefits properly available to them under the treaty. While the U.K. has agreed to defer implementation of this legislation for the time being, this incident makes it clear that state worldwide unitary taxation is adversely affecting the United States' foreign economic relations.

While the Administration has proposed federal legislation prohibiting worldwide unitary taxation and limiting state taxation of foreign dividends, I would welcome swift legislative or administrative action by your state to terminate your state's use of the worldwide unitary method of taxation and to limit appropriately your state's taxation of foreign source dividends.

Sincerely yours,

George P. Shultz

APPENDIX B

THE WHITE HOUSE

Office of the Press Secretary

For Immediate Release November 8, 1985

STATEMENT BY THE PRESIDENT

Since early in this Administration, we have been working with the states, the business community, and foreign governments in an effort to resolve issues related to state use of the worldwide unitary method of taxation. At this time I believe it appropriate for the Federal Government to state its support for the *concept* of legislation that would:

1. Effect a requirement that multinationals be taxed by states only on income derived from the territory of the United States ("the water's edge requirement"), and

2. Address the question of equitable taxation of foreign source dividends.

We hoped that by this time these principles would have been enacted by the various states that have unitary taxation. Since states have not universally accepted these principles, I am instructing the Secretary of the Treasury to initiate the process of *crafting* Federal legislation to incorporate these principles into law and to work with the Congress for passage, and also, where appropriate, to enter into negotiations to amend double taxation agreements. I am also instructing the Secretary of the Treasury to pursue enactment of the domestic "spreadsheet" legislation, which has been previously proposed, and which is designed to assist nonunitary states with tax enforcement respecting multinational corporations in order to promote full taxpayer disclosure and accountability.

Further, I am instructing the Attorney General to ensure that the United States' interests are represented in appropriate controversies and cases consistent with this approach.

CERTIFICATE OF SERVICE

It is hereby certified under penalty of perjury that service of the foregoing brief amicus curiae has been made on counsel by mailing a copy to each on this ____ day of May, 1991, in envelopes, with postage prepaid, properly addressed to each of them, respectively, as follows:

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APPENDIX I

FTB Notice No. 89-714, Franchise Tax Board, November 17, 1989.

Corporation franchise (income) — Refund claims — Deferrals of action on refund claims until outcome of pending appeal.— Deferrals of action on corporate tax refund claims will be available to taxpayers who have filed claims for refund that are limited to the question of law presented in the pending appeal of *Barclays Bank International v. Franchise Tax Board* (see ¶ 401-552 for the lower court's decision). In *Barclays*, the California Court of Appeal has been asked to decide the "one voice" issue; that is, whether, in determining the corporate tax liabilities of an entity that is part of a multinational enterprise involving a foreign parent corporation, California's imposition of the requirements of the worldwide combined reporting is consistent with the federal foreign affairs powers contained in the Commerce Clause of the United States Constitution.

No deferrals will be available for claims for refund that raise factual issues such as whether a unitary business exists or whether an individual taxpayer's cost of compliance is constitutionally impermissible; those claims will be acted upon using existing procedures.

Deferrals will be available only when the matter is in the claim status, with no action having been taken with respect to the claim. The notice outlines how this requirement applies at the audit level, the protest level, and the appeal level. A taxpayer seeking deferral of action should specify in the taxpayer's claim for deferral that the claim is limited to the "one voice" issue currently before the Third Appellate District Court in the *Barclays* case, and that the taxpayer requests deferral of action pending the outcome of that case pursuant to FTB Notice 89-714.

APPENDIX J

California Code of Regulations, Title 18

§ 25137-6. Combined Reports Including Foreign Country Operations.

(a) In General

(1) Unitary Business. A taxpayer is engaged in a unitary business (or a single business within the meaning of Reg.25120(b)) when its activities within the state contribute to or are dependent upon its activities without the state. A unitary business exists when there is unity of ownership, unity of operation and unity of use.

(2) Translation Method for Determining Income. The translation method to be used for determining income shall be the "profit and loss method" as set forth in this regulation. This method excludes unrealized exchange rate gain or loss resulting from the restatement of assets or liabilities, while taking into account exchange gains or losses attributable to income transactions.

(3) General Applicability of UDITPA Regulations. The general regulations for UDITPA, Regs. 25120-25139, inclusive, shall be applicable except as otherwise provided in this regulation.

(b) Determination of income.

(1) The income of a unitary business with operations in foreign countries shall be computed in the following manner:

(A) A profit and loss statement shall be prepared for each foreign branch or corporation in the currency in which the books of account of the branch or corporation are regularly maintained.

(B) Adjustments shall be made to the profit and loss statement to conform it to the accounting principles generally accepted in the United States for the preparation of such statements except as modified by this regulation.

(C) Adjustments shall be made to the profit and loss statement to conform it to the tax accounting standards under Division 2, Part 11 of the Revenue and Taxation Code.

(D) The profit and loss statement of each branch or corporation, whether U.S. or foreign, shall be translated into the currency in which the parent company maintains is books and records in accordance with sub-section (b)(4).

(E) Business and nonbusiness income as determined under California law shall be identified and segregated. For general definition, rules and examples for determining business and nonbusiness income, see Regulation 25120.

(F) Nonbusiness income shall be allocated to a specific state pursuant to the provisions of Sections 25124 to 25127, inclusive of Division 2, Part 11 of the Revenue and Taxation Code.

(G) Business income shall be included in the combined report prepared for the unitary business and shall be apportioned on the basis of the appropriate formula for the business.

(H) Income from California sources shall be expressed in dollars in accordance with subsection (b)(4) and the taxes computed accordingly.

(2) In lieu of the procedures set forth in subsection (b)(1) and subject to the determination of the Franchise Tax Board that it reasonably reflects income, a unitary business with operations in a foreign country may determine its income on the basis of the consolidated profit and loss statement prepared for the related corporations of which the unitary business is a member which is prepared for filing with the Securities and Exchange Commission. If the business is not required to file with the Securities and Exchange Commission, the consolidated profit and loss statement prepared for reporting to shareholders and subject to review by an independent auditor may be used.

(A) Adjustments shall be made, if necessary to:

(i) conform to the accounting principles generally accepted in the United States for the preparation of such statements, except as modified by this regulation;

(ii) conform to the tax accounting standards as required under Division 2, Part 11 of the California Revenue and Taxation Code; and

(iii) eliminate unrealized gain and losses resulting from the restatement or revaluation of assets or liabilities to reflect changes or fluctuations in currency values.

(B) Business and nonbusiness income as determined under California law shall be identified and segregated. For definitions, rules and examples for determining business and nonbusiness income, see generally Regulation 25120.

(C) Nonbusiness income shall be allocated to specific states pursuant to the provisions of Sections 25124 to 25127, inclusive of the Revenue and Taxation Code.

(D) Business income shall be included in the combined report prepared for each unitary business and will be apportioned on the basis of the appropriate formula for each business.

(E) Income from California sources shall be expressed in dollars in accordance with subsection (b)(4) and the taxes computed accordingly.

(3) For purposes of subsections (b)(1)(B), (b)(1)(C), and (b)(2)(A), the following rules shall apply:

(A) Accounting adjustments to be made to conform profit and loss statements to those utilized in the United States

(i) Include but are not limited to the following:

(I) Clear reflection of income. Any accounting practice designed for purposes other than the clear reflection on a current basis of income and expense for the taxable year shall not be given effect. For example, an adjustment shall be required where an allocation is made to an arbitrary reserve out of current income.

(II) Physical assets, depreciation, etc. All physical assets, including inventory when reflected at cost, shall be taken into account at historical cost computed either for individual assets or groups of similar assets. The historical cost of such an

asset shall not reflect any appreciation or depreciation in its value or in the relative value of the currency in which its cost was incurred. Depreciation, depletion, and amortization allowances shall be based on the historical cost of the underlying asset, and no effect shall be given to any such allowance determined on the basis of a factor other than historical cost.

(III) Valuation of assets and liabilities. Any accounting practice which results in the systematic undervaluation of assets or overvaluation of liabilities shall not be given effect, even though expressly permitted or required under foreign law, except to the extent allowable under subsection (b)(3)((B). For example, an adjustment shall be required where inventory is written down below market value.

(IV) Income equalization. Income and expense shall be taken into account without regard to equalization over more than one accounting period; and any equalization reserve or similar provision affecting income or expense shall not be given effect, even though expressly permitted or required under foreign law.

(ii) Currency gains or losses on closed transaction are includible, but no adjustments shall be made, or otherwise reflected, for unrealized gains or losses resulting from the restatement or revaluation of assets or liabilities to reflect changes or fluctuations in currency values. A closed transaction is one where any foreign exchange position taken by a corporation has been terminated by exchanging the foreign currency for the currency in which the individual corporation maintains its books and records normally conducts its business affairs. In the case of a borrowing in a foreign currency, the transaction shall not be deemed closed until repayment is made.

(B) The tax accounting adjustments to be made shall include, but are not limited to, the following:

(i) Accounting methods. The method of accounting shall reflect the provisions of Section 24651 of the Revenue and Taxation Code and the regulations thereunder.

(ii) Inventories. Inventories shall be taken into account in accordance with the provisions of Sections 24701 through 24706 of the Revenue and Taxation Code and the regulations thereunder, except Regulations 24702-24706(b)(5).

(iii) Depreciation, depletion, and amortization. Depreciation, depletion and amortization are to be computed in accordance with California law.

(iv) Elections.

(I) Elections required to be made for purposes of determining income under Division 2, Part 11 of the Revenue and Taxation Code of all California reporting entities shall be made in accordance with applicable provisions of such law and the regulations adopted pursuant thereto.

(II) Elections required to be made for purposes of determining income under Division 2, Part 11 of the Revenue and Taxation Code for entities which are not subject to taxation by California but are required to be included in the combined report for the unitary business shall be made by agreement of all entities required to report to California in accordance with applicable provisions of such law and the regulations adopted pursuant thereto. If agreement cannot be reached, such income shall be reported on the basis of United States generally accepted accounting principles.

(C) No adjustment shall be required under subsections (b)(3)(A) and (b)(3)(B) unless it is material. Whether an adjustment is material depends upon the facts and circumstances of the particular case, including the amount of the adjustment, its size relative to the general level of the corporation's total assets and annual profit or loss, the consistency with which the practice has been applied, and whether the item to which the adjustment relates is of a recurring or a nonrecurring nature.

(4) For purposes of determining income, necessary translations shall be made at the following exchange rates:

(A) Depreciation, depletion, or amortization shall be translated at the appropriate exchange rate for the translation

period in which the historical cost of the underlying asset was incurred.

(B) All other items shall be translated at either the endof-year exchange rate or at the simple average exchange rate for the translation period. Income repatriated during the year shall be translated at the exchange rate at date of repatriation. It is presumed that the translation rate used in preparing the consolidated profit and loss statement for financial reporting purposes is proper absent a showing that some other method is appropriate.

A change from end-of-year rates or average rates may not be made without the permission of and on such conditions as the Franchise Tax Board may prescribe.

(c) Computation of Factors. In computing the formula factors, the following rules shall apply:

(1) Property Factor.

(A) Fixed assets shall be valued at original cost as defined in Reg. 25130(a) and translated at the exchange rate as of the date of acquisition.

(B) Rented property, capitalized at eight times its annual rental rate, shall be translated at the simple average of the beginning and end-of-year exchange rate.

(C) Inventories shall be valued at original cost and shall be translated at the exchange rate as of the date of acquisition.

(D) For purposes of calculating the property factor of financial corporations, financial assets are translated at the year-end rate and are defined as assets reflecting a fixed amount of currency, such as cash on hand, bank deposits, and loans and accounts receivable. Securities held, or reasonably expected to be held, for less than six months shall be translated at year-end rates. If a security is held, or reasonably expected to be held, for more than six months, it shall be translated at the appropriate exchange rate for the translation period in which the historical cost of the asset is determined.

(E) The property factor shall be computed in the currency of the parent company unless the taxpayer requests and the Franchise Tax Board determines that computing the factor in dollars or any other currency fairly reflects the taxpayer's activities in California.

(2) Payroll and Receipts Factors.

(A) Translation shall be made at the simple average of the beginning and end-of-year exchange rates unless there is a substantial fluctuation, as described in subsection (d)(2).

(B) Where the value of the foreign currency does fluctuate substantially, as described in subsection (d)(2), the exchange rate appropriate to that period shall be either (1) a simple average of the month-end rates, or (2) a weighted average taking into account the volume of transactions (reflected by the amount being translated) for the calendar months ending with or within that period.

(C) In computing the payroll and receipts factors, translation shall be made into the parent company's currency in order to properly determine the percentage factor to be used unless the taxpayer requests and the Franchise Tax Board determines that computing the factors in dollars or any other currency fairly reflects the taxpayer's activities in California.

(d) Exchange Rates.

(1) For purposes of preparing combined reports, exchange rates may be derived from any source which is demonstrated to the satisfaction of the Franchise Tax Board to reflect actual transactions conducted in a free market and involving representative amounts. In the absence of such demonstration, the exchange rates taken into account in computation of the earnings and profits of the foreign corporation shall be determined by reference to the free market rate set forth in the pertinent monthly issues of International Financial Statistics or successor publications of the International Monetary Fund.

(2) In general, the extend of fluctuation is substantial if the closing rate for any calendar month ending within the period

varies by more than 10 percent from the closing rate for any preceding calendar month ending within the period.

(e) Application of Regulation.

(1) In computing the income and any of the factors required for a combined report, the Franchise Tax Board shall consider the effort and expense required to obtain the necessary information. In appropriate cases, such as when the necessary data cannot be developed from financial records maintained in the regular course of business, the Franchise Tax Board may accept reasonable approximations.

(2) A taxpayer may request an advance determination under subsections (b)(2), (b)(3)(C), (c)(1), (d)(1) or any other provision of this regulation by submitting a determination request to the Legal Division of the Franchise Tax Board. Such a determination shall be made on an individual basis and shall be limited to the particular facts or circumstances set forth in the determination request. The facts and circumstances upon which a determination is made remain subject to review. Failure to request or to obtain a favorable advance determination will not preclude consideration of requested variances in subsequent proceedings.

(7)

No. 92-1384

In The

Supreme Court of the United States

October Term, 1992

BARCLAYS BANK PLC,

Petitioner,

v.

FRANCHISE TAX BOARD,
An Agency of the State of California,

Respondent.

**On Petition For A Writ Of Certiorari
To The Court Of Appeal
Of The State Of California
In And For The Third Appellate District**

BRIEF OF RESPONDENT FRANCHISE TAX BOARD IN OPPOSITION TO PETITION FOR WRIT OF CERTIORARI

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QUESTIONS PRESENTED

1. Whether the California Supreme Court properly declined to apply a dormant Commerce Clause analysis and properly held that, due to congressional acquiescence, California did not violate the Foreign Commerce Clause by application of worldwide combined reporting to determine the taxable California income of the Barclays taxpayers.

2. If a dormant Commerce Clause analysis were appropriate, would California's use of worldwide combined reporting violate the discrimination element of such a dormant analysis even though California applied the same tax and reporting requirements upon all taxpayers, whether their multinational group was headed by a foreign or a domestic parent corporation?

3. Even though California's practice is held to be valid under the Foreign Commerce Clause, whether California's application of worldwide combined reporting to the Barclays taxpayers is nevertheless preempted by the United States Constitution as an intrusion into an inherently federal area; specifically, whether the Executive Branch's foreign affairs powers can eclipse Congress' exercise of its treaty and Commerce Clause powers to permit such state use of worldwide combined reporting.

4. Whether California's tax reporting procedures, which permit taxpayers to avoid high compliance expenses through the use of reasonable approximations, and which provide for court review of any claimed abuse of administrative discretion, deny taxpayers due process of law.

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STATUTORY AND CONSTITUTIONAL PROVISIONS

Petitioner Barclays has included some of the relevant constitutional and statutory provisions in Appendix F to the petition. Petitioner also sets forth the applicable regulation (California Code of Regulations title 18, section 25137-6) as Appendix J to its petition. Appendix A to this brief in response contains the following: a portion of

article II, section 2 of the United States Constitution and California Revenue and Taxation Code section 25110.

SUPPLEMENTAL STATEMENT OF THE CASE

Respondent Franchise Tax Board believes that petitioner Barclays' statement regarding the case (Petition for Certiorari ("Pet.") 4-13) contains significant omissions. Therefore, pursuant to Rule 15.1, the Franchise Tax Board provides this Court with this supplemental statement. This supplement should be read in conjunction with and in addition to both Barclays' statement and the California Supreme Court's statement of the factual, procedural, legislative and case law background, which is included herein by reference. Most citations herein are to the appendices to the Petition for Writ of Certiorari (for example, "A-38" is a citation to page 38 of Appendix A to the petition).

1. Petitioner's California Tax Filings and the Franchise Tax Board's Adjustments.

The Barclays Group conducted its business in California through two corporate entities during the year in issue. Barclays Bank of California ("Barcal"), a wholly owned, California incorporated, subsidiary of Barclays Bank International ("BBI"), conducted a commercial banking business in the State of California. A-38, ¶ 9. BBI, a wholly owned, United Kingdom incorporated, subsidiary of Barclays Bank Limited ("BBL"), conducted business in California as a banking agency. A-36, ¶ 1. BBI was

engaged in general retail and commercial banking, leasing, and consumer and commercial finance, directly or through subsidiaries, in approximately fifty-five (55) countries and territories during 1977. A-37, ¶ 2.

Both corporations filed California Franchise Tax returns for the year at issue. Barcal filed a return which included in its calculations only its individual income and activities. A-39-40, ¶ 19. BBI filed a return based upon a worldwide combined report which included all of its worldwide income and activities, and the worldwide income and activities of all of its controlled subsidiaries, including Barcal. A-39, ¶ 18. The income which served as a measure of BBI's California tax was determined by applying an apportionment formula (which compared BBI's California activities to the worldwide activities of BBI and its subsidiaries) to the worldwide net income of BBI and its subsidiaries.[1]

At audit, the Franchise Tax Board determined that Barcal, BBI and all of BBI's other subsidiaries were part of a single unitary business which also included BBL, the parent company of BBI, and all of the other controlled subsidiaries of BBL. A-38, ¶ 14. As a result of this determination, the Franchise Tax Board recomputed the California tax liabilities of Barcal and BBI upon the basis of a combined report which included all of the income and

[1] The California Court of Appeal recognized that the actual cost to BBI of filing such a return on a worldwide apportionment basis, using reasonable approximations, was "relatively modest," referring to earlier costs "on the order of $900 to $1,250 per year for three annual tax returns filed in the 1970's." D-19 and n. 9.

activities of the entities determined to be in the unitary business, from which the California net incomes of Barcal and BBI were calculated by formulary apportionment. A-38, ¶ 15; A-39, ¶ 16; C-5. For purposes of this litigation it is agreed that BBL and all of its majority-owned subsidiaries, including BBI and Barcal, are a single unitary business. C-2, A-37 ¶ 8, A-42 ¶ 27.

BBI and Barcal pursued administrative remedies with the Franchise Tax Board, and modifications were made to the original audit calculations of the amount of income attributed to California. BBI and Barcal paid the modified assessments, and both filed suits for refund asking for the return of all tax and interest amounts paid which were over the amounts paid with their original returns. Neither BBI (A-41, ¶ 25) nor Barcal (A-41, ¶ 24) has claimed that the amount of tax paid with their original returns was erroneous.

2. Awareness of the Use of the Worldwide Combined Report Method of Determining Income.

There is evidence which suggests international awareness of the use of formula apportionment and the unitary method at least from the mid-1950's onward. C-33. As early as the late 1940's the United States negotiators of Friendship, Commerce and Navigation agreements recognized the existence of formulary approaches. C-33 to C-34. The use of formula apportionment as an alternative to the arm's-length/separate accounting method penetrated the international financial and diplomatic consciousness as early as 1924. C-32.

The debate regarding the States' use of worldwide combined reporting ("WWCR") methodologies was recognized by the Executive Branch of the federal government as spanning at least two decades as of 1984. C-33, n. 14. From at least as far back as 1965, Congressional bills dealing with the subject of the States' use of WWCR have been introduced (C-31); these have included measures sponsored by the United States Treasury. For over 25 years, senior tax and foreign policy officials of the Executive Branch had been aware of the complaints and demands of foreign governments regarding worldwide combined reporting. C-27.

3. The United States/United Kingdom Tax Treaty.

In 1975, the Ford administration negotiated a bilateral income tax convention ("US/UK Treaty") with the United Kingdom which would have prevented the use of the WWCR methodology here at issue. C-28. In 1978, with explicit recognition of the "negative implications" of its act, the United States Senate *rejected* the US/UK Treaty as negotiated by the Executive Branch. C-27. The treaty was approved only after the provision prohibiting the states' use of worldwide combined reporting was removed. C-27. In the wake of that Senate rejection, the Executive Branch scuttled its effort to achieve a treaty-imposed curb on the states' use of WWCR. C-28 and C-37, n. 20.

The Parliament of the United Kingdom ratified the treaty, without the clause prohibiting the states' use of WWCR, in 1980. C-30, n. 11 and A-56, ¶ 40gg. The ratification occurred after representatives of the two countries negotiated the Third Protocol to the Treaty. A-56,

¶ 40gg. The government of the United Kingdom, while regretting the defeat of the prohibition as preliminarily negotiated in 1975, recognized that the US/UK Treaty as finally negotiated and ratified was "a fair and balanced agreement." A-44, ¶ 32c; Exh. 32c.

In 1985 Parliament enacted legislation which empowered the Prime Minister to institute retaliatory taxation against United States companies if the use of WWCR was continued. A-49, ¶ 34. This power has never been exercised. The Executive Branch has indicated to Congress that exercising this power would constitute a clear violation of the treaty by the United Kingdom. Exh. 37i, p. 12.

4. The California Water's-Edge Election.

In 1986 California enacted legislation which allows both foreign and domestic based businesses to elect out of the use of WWCR in favor of a "water's-edge" method, which in general confines WWCR to United States incorporated entities, certain tax advantage subsidiaries of United States corporations and, in limited circumstances, some portion of foreign incorporated entities. C-36 and A-73, ¶ 55; Cal. Revenue and Taxation Code § 25110 (see Appendix A hereto). The enactment of the California water's-edge legislation prompted senior Treasury officials to retreat from their previous insistence that Congress prohibit state use of worldwide formula apportionment. C-36 to C-37.

5. This Court's Recognition of the Merits of Formulary Apportionment.

As noted above, worldwide combined reporting is based upon formulary apportionment of the total net income of a unitary business. Use of such formula apportionment of income does not result in taxation of non-California corporations or in taxation of non-California income; it is only the means of determining what portion of the unitary income can be fairly attributed to the part of the unitary business that is actually being carried out in California. *Container Corporation* v. *Franchise Tax Board*, 463 U.S. 159, 164-65, 184, 192 (1983) (hereinafter "*Container*").

The *Container* decision, *id.*, upheld the constitutionality of California's use of unitary apportionment and WWCR as to worldwide unitary businesses headed by domestic corporations. In *Container*, this Court held California's version of WWCR to be a "proper and fair method of taxation" (463 U.S. at 184) which reflects "a reasonable sense of how income is generated" (*id.* at 169-70) and which avoids the "basic theoretical weaknesses" of arm's length/separate accounting methods (*id.* at 181), the alternative to WWCR which petitioner Barclays claims must be applied to the Barclays taxpayers. Among the separate accounting weaknesses pointed out in *Container* are that separate accounting "is subject to manipulation and imprecision, and often ignores or captures inadequately the many subtle and largely unquantifiable transfers of value that take place among the components of a single enterprise" (*id.* at 164-65).

As this Court stated in *Trinova Corp.* v. *Michigan Dept. of Treasury*, ___ U.S. ___, 111 S.Ct. 818, 831 (1991), "since *Underwood Typewriter Co.* v. *Chamberlain*, 254 U.S. 113 (1920), we have recognized the impracticability of assuming that all income can be assigned [by geographic designation] to a single source." As this Court has very recently stated, "The principal virtue of the unitary business principle of taxation is that it does a better job of accounting for 'the many subtle and largely unquantifiable transfers of value that take place among the components of a single enterprise' than, for example, geographical or transactional accounting." *Allied-Signal, Inc.* v. *Director, Div. of Taxation*, ___ U.S. ___, 112 S.Ct. 2251, 2261 (1992).

ARGUMENT

I

THE CALIFORNIA SUPREME COURT HAS PROPERLY APPLIED THIS COURT'S *WARDAIR* DECISION IN HOLDING THAT CONGRESSIONAL ACQUIESCENCE IN CALIFORNIA'S USE OF WORLDWIDE COMBINED REPORTING IS DETERMINATIVE OF THE COMMERCE CLAUSE ISSUE, WITH NO NEED FOR ANY DORMANT COMMERCE CLAUSE ANALYSIS.

The California Supreme Court has correctly applied existing precedent of this Court in a manner fully consistent with this Court's February 1993 holding in *Itel Containers International Corp.* v. *Huddleston*, ___ U.S. ___, 113 S.Ct. 1095 (1993), the most recent Foreign Commerce

Clause tax case. There is no need for this Court to exercise its jurisdiction to revisit this constitutional area at this time.

The California Supreme Court's Commerce Clause holding, based upon *Wardair Canada, Inc.* v. *Florida Dept. of Revenue*, 477 U.S. 1 (1986) (hereinafter "*Wardair*"), concludes that congressional actions show that Congress has acquiesced in the state tax practice which Barclays is challenging. That being so, the California Supreme Court pointedly did not engage in any dormant Commerce Clause analysis. C-39. Most of Barclays' petition is devoted to assertions which are relevant only to a dormant Commerce Clause analysis. Other than a few citations to *Wardair*, Barclays confines its non-dormant Commerce Clause contentions to several pages near the end of its Commerce Clause argument. Pet. 20-23.

In *Wardair* this Court cautioned that "It would turn dormant Commerce Clause analysis entirely upside down to apply it when the Federal Government has acted, and to apply it in such a way as to reverse the policy that the Federal Government has elected to follow." *Id.* at 12. By criticizing the California Supreme Court for "disregard[ing]" established dormant Commerce Clause criteria (Pet. 16) in a case where Congress has acted to allow the state tax practice in issue, it appears that the Barclays petition would have this Court require a dormant Commerce Clause analysis even when the empowered branch

of the Federal Government has acted to permit the challenged state tax.[2]

In *Container Corp. of America* v. *Franchise Tax Board*, 463 U.S. 159 (1982) (hereinafter "*Container*"), this Court upheld the constitutionality of California's worldwide combined reporting method as applied to a multinational unitary business with a domestic ultimate parent. This Court reserved the question of whether it would reach the same result if (as in this case) the ultimate parent corporation were foreign. 463 U.S. at 193-97.[3]

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[2] There is no need or basis to apply in this case the results of dormant Commerce Clause analysis from such cases as *Kraft General Foods* v. *Iowa Dept. of Revenue*, ___ U.S. ___, 112 S.Ct. 2365 (1992), cited Pet. at 13, 15, 18 n. 18, and 23. The fact that the dormant Commerce Clause analysis is broadened by two additional elements in the foreign commerce context as compared to the domestic context (*id.* at 2370) cannot affect Congress' total power to remove *all* Commerce Clause restrictions upon any state tax practice in which Congress chooses to acquiesce. See also n. 5 below at p. 14.

[3] When dealing with the question of the "one voice" of the federal government in foreign commerce, the *Container* Court only considered whether California's application of WWCR *violated* either one of two branches of the one voice standard, indicating that the state tax "will violate the 'one voice' standard if it *either* implicates foreign policy issues which must be left to the Federal Government [the dormant clause branch of the standard] *or* violates a clear federal directive." 463 U.S. at 194 (emphasis by the Court). Thus the only non-dormant Foreign Commerce Clause analysis in *Container* was a consideration whether the one voice had spoken to *preempt* California's use of WWCR. *Id.* In the words of the *Barclays* trial court, *Container* "did not address the question of whether such policy was expressed Congressionally *for* it." A-31 (emphasis by the court). The *Container* Court's consideration of "specific indications of congressional intent" (463 U.S. at 196) was restricted to the preemptive analysis, with the Court deciding that "we cannot conclude that the California tax at issue here is preempted by federal law. . . . " *Id.* at 197. Since the *Container* Court did not even consider whether the federal government's one voice had spoken to *permit* California's use of WWCR, it certainly is not inconsistent with *Container* to apply the later *Wardair* analysis in the present case to find such permission.

Three years after *Container*, in *Wardair*, this Court provided the analytic tool which, as properly applied by the California Supreme Court to uncontradicted facts in the current record, mandates the resolution of this reserved question in favor of California's use of WWCR. Noting that a *dormant* Commerce Clause analysis need not be applied when federal law indicates an authoritative federal decision to *permit* the challenged state tax, this Court held in *Wardair* that such a permissive decision can exist by *implication*, i.e., under circumstances where there is no explicit statement of such permission. Such "implications" are to be drawn from "the *law* as it presently stands," not from any "*aspiration*" for what the law might become. *Id.* at 10 (emphasis by the Court).

In *Wardair*, a Canadian airline challenged Florida's imposition of a tax on all aviation fuel sold within the state insofar as that tax was assessed on fuel used by foreign airlines exclusively in foreign commerce. On the Commerce Clause issue in *Wardair*,[4] the taxpayer and the

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[4] The *Wardair* Court also held that the Florida tax was not preempted by the Federal Aviation Act, but the Court explicitly stated that it did not rely on a permissive provision of that act "to answer the Commerce Clause issue" present in *Wardair*. 477 U.S. at 6-7. Thus Barclays errs in implying (Pet. 21) that the Federal Aviation Act served in any way as a basis for the *Wardair* Commerce Clause holding.

Solicitor General as amicus curiae argued that the Florida tax unconstitutionally interfered with the ability of the federal government to speak with one voice because there was a federal policy to exempt such fuel from tax. As evidence of the alleged federal "policy," Wardair and the Solicitor General principally relied on (1) the Chicago Convention on International Civil Aviation, an international treaty to which the United States and 156 other countries, including Canada, are parties; (2) a resolution adopted by the International Civil Aviation Organization in 1966; and (3) more than 70 bilateral agreements into which the United States has entered with various countries dealing with international aviation. Discussing each of these in turn, this Court pointed out: (1) that the Chicago Convention by its terms precludes the imposition of local taxes on fuel only when the fuel already is on board an arriving aircraft, thus raising a "negative implication" that there had been "a decision by the parties to that convention to address the problem of [state and local taxation] by curtailing and limiting only some of the localities' power to tax, while implicitly preserving other aspects of that authority" (*id.* at 10); (2) that the resolution adopted by the ICAO, while it endorses an international scheme of tax exemption, is merely the work product of an international organization of which the United States is a member and has no force of law (*id.* at 11); and (3) that while most of the 70 bilateral agreements commit the United States to refrain from imposing national taxes of the type imposed by Florida, in none of these agreements has the United States agreed to deny the states the power to tax the sale of aviation fuel; in particular, the agreement between the United States and Canada makes *no*

mention of taxation by political subdivisions, "an omission which must be understood as representing a policy choice by the contracting parties. . . . " *Id.* at 11.

This Court went on to say:

> "What all of this makes abundantly clear is that the Federal Government has not remained silent with regard to the question of whether States should have the power to impose taxes on aviation fuel used by foreign carriers in international travel. By *negative implication* arising out of more than 70 agreements entered into since the Chicago Convention, the United States has at least acquiesced in state taxation of fuel used by foreign carriers in international travel. Again, in the U.S.-Canadian Agreement only 'national' charges are barred, and we presume that drafters from two federalist nations understood this as representing a choice not to preclude local taxation. It would turn dormant Commerce Clause analysis entirely upside down to apply it when the Federal Government has acted, and to apply it in such a way as to *reverse* the policy that the Federal Government has elected to follow." *Id.* at 12 (emphasis in original).

Thus in *Wardair* the federal government had considered whether to bar a type of tax practice by international agreement, but the *states* were not restricted from applying that tax practice when the agreements were finally adopted as a part of United States law. Under this Court's *Wardair* rule, the implications to be drawn from such an action establish that in formulating federal law Congress

has elected to permit the states to apply such a tax practice. *Id.* at 10, 12.[5]

In holding that the *Wardair* rule was applicable in the present case, the California Supreme Court placed its primary reliance on the United States/United Kingdom ("US/UK") Treaty which was negotiated and ratified in the 1970's. Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasions with Respect to Taxes on Income and Capital Gains, Dec. 31, 1975, U.S./U.K., 31 U.S.T. 5668 (Exh. 40gg). For the first and only time, the federal Executive Branch negotiated a provision for that treaty, article 9(4), which would have explicitly prohibited any state's use of worldwide combined reporting ("WWCR"). C-29.

[5] It must be kept in mind that the United States Constitution gives the power to regulate foreign and interstate commerce to *Congress*. U.S. Const. art. I, § 8(3); Pet. App. F. Thus, as to foreign or interstate commerce matters, congressional action prevails over any conflicting actions or desires of the Executive Branch. See *United States* v. *Curtiss-Wright Export Corp.*, 299 U.S. 304 (1936); *United States* v. *Guy W. Capps, Inc.*, 204 F.2d 655 (4th Cir. 1953), aff'd on other grounds, 348 U.S. 296 (1955). If Congress has exercised its commerce powers so as to permit state action, there cannot possibly be any violation of the Commerce Clause. Once such permission is ascertained, "any action taken by a State within the scope of the congressional authorization is rendered invulnerable to Commerce Clause challenge." *Western & Southern L.I. Co.* v. *Bd. of Equalization*, 451 U.S. 648, 653 (1981); see also *Wardair*, 477 U.S. at 12-13. Given Congress' total power in regulating foreign and interstate commerce, in granting such permission Congress is unrestricted by any of the policy standards which would apply in a *dormant* Commerce Clause context.

After much debate, and several votes in the Senate, the treaty was only ratified after that provision was rendered totally inapplicable to the states. 124 Cong. Rec. 18416 (June 22, 1978) (Exh. 36c), 19076 (June 27, 1978) (Exh. 36d); C-29. After more bargaining with the United Kingdom, wherein the United Kingdom exacted other federal tax concessions from the United States, the United Kingdom accepted the treaty with the prohibition of WWCR only applicable to the national governments, not to the states. 31 U.S.T. 5709, 5713 (Exh. 40gg). Thus the states' use of WWCR was directly considered as a tax issue during the formulation of the treaty, but the *states'* use of WWCR ultimately was not restricted in the final adoption of the treaty as a part of United States law.

The US/UK Treaty provides a perfect context for the application of the *Wardair* rule: a clear congressional consideration of whether a state tax practice (WWCR) should be permitted, and a final ratification of a treaty which by clear implication permitted the states' application of that tax practice (WWCR). At the time of the final Senate vote, the clear and acknowledged choice before the Senate was either to ratify the US/UK treaty while permitting the states to use WWCR or (since ratification with original article 9(4) had proved impossible) not to ratify the treaty. See 124 Cong. Rec. 18709-12 (June 23, 1978) (statements of Senators Byrd, Church, Javits, Stevens, Sparkman, Cranston and Packwood (Exh. 36d). By more than the required two-thirds vote (82 yeas, 5 nays), the Senate chose to ratify the treaty while permitting (by implication) state use of WWCR. 124 Cong. Rec. 19076 (June 27, 1978) (Exh. 36d). In the words of the *Wardair* decision, the Senate has "at least acquiesced" in the use of WWCR by

the states, and under the *Wardair* holding such acquiescence is fully sufficient to establish that the federal government has "affirmatively decided to permit" state use of WWCR. 477 U.S. at 12-13.[6]

The California Supreme Court correctly analogized the present case to *Wardair*:

> "The parallels between this evidence of 'governmental silence' or refusal to act and that regarded as decisive in *Wardair, supra*, 477 U.S. 1, seem to us both evident and compelling. As in *Wardair*, an international agreement (here the bilateral income tax treaty between the United States and the United Kingdom) demonstrates that while federal executive branch officials *aspired* to eliminate a state tax practice (here the use of formula apportionment to calculate the tax liability of foreign-based multinationals), 'the *law* as it presently stands acquiesces' in the states' continued use of that practice. As in *Wardair*, the 'negative implications' of international agreements (here the tax treaty as ratified by the Senate) support recognition of a federal policy that *acquiesces* in the states' tax practice. And certainly, in the circumstances of Senate consideration detailed above, the explicit removal of 'political subdivisions' from the scope of article 9(4) effected by the Church reservation, like the omission of restrictions on taxation by political subdivisions in the international agreements considered in *Wardair*, 'must be understood as representing a policy choice by the contracting parties.' (*Wardair, supra*, 477 U.S. at p. 11." C-29 to C-30 (emphasis in original; footnote omitted).

[6] Contrary to Barclays' attempt to characterize the Senate's ratification of the treaty as a "stalemate" (Pet. 21 n. 21), the final outcome was a clear defeat for those who had attempted to bar precisely the type of state tax practice which Barclays is challenging in this case.

Recognizing that formula apportionment such as WWCR has been a matter of international interest from at least the mid-1950's (C-33 to C-34), and noting that indications of such federal acquiescence also were to be found in the history of other bilateral income tax treaties (C-31 to C-34) and in legislative histories of congressional bills (C-31), the California Supreme Court applied *Wardair* to hold that (1) California's application of WWCR in this case has been permitted by Congress under its Commerce Clause powers, and (2) since Congress has acted to permit such application, no dormant Commerce Clause analysis was necessary. Respondent Franchise Tax Board submits that one does not have to do more than apply the *Wardair* rule to the US/UK treaty to determine that the California Supreme Court's holdings were fully consistent with all current precedents of this Court. The California Supreme Court has not formulated and applied a "substitute test" of its own (see Pet. 11, 21, 23) to reach these holdings; it has correctly applied the test provided to it by this Court in *Wardair*.

A primary basis for Barclays' current petition is that the California Supreme Court somehow has gone beyond *Wardair* and other more recent decisions of this Court in holding that express Congressional permission is not necessary if the actions of Congress imply congressional acquiescence in a state tax procedure. Even if there could be any question on this point after *Wardair*, any such question must be deemed fully settled by this Court's

most recent decision involving the Foreign Commerce Clause: in *Itel Containers International Corp.* v. *Huddleston*, *supra*, decided on February 23 of this year, this Court concluded its Foreign Commerce Clause discussion with a holding that Congress had acted by inference to permit the Tennessee sales tax involved in that case. In *Itel*, consistently with *Wardair*, this Court inferred the congressional permission from the simple fact that the state tax did not fall within the types of taxes which had been eliminated in "various conventions, statutes and regulations that restrict a State's ability to tax international cargo containers in defined circumstances . . . . " 113 S.Ct. at 1105. The single-justice dissenting opinion in *Itel* criticized the majority for "finding congressional authorization for the tax in congressional silence," by "infer[ring] permission for the tax from Congress' supposed failure to prohibit it." 113 S.Ct. at 1110 (Blackmun, J., dissenting). This criticism is quite similar to the criticism of the *Wardair* majority opinion in the single-justice *Wardair* dissent; it is strikingly similar ~~to the criticism~~ which the Barclays petition has aimed at the California Supreme Court. While the Barclays petitioner may not like the *Wardair* approach, there can be no valid question that the California Supreme Court's application of the *Wardair* rule is fully consistent with the current rulings of this Court.

In the present case, the congressional permission is much more clearly manifested than what was held to be sufficient in *Itel*: here the congressional record clearly establishes that Congress had before it the specific proposal to eliminate the type of state tax procedures which are now at issue. By failing to attain the vote required by

the Constitution, that proposal was rejected by the Congress, and under *Wardair* that rejection is a part of the ratified U.S./U.K. Treaty's body of law under the Foreign Commerce Clause. Given the clarity and specific nature of the record in the present case as compared to the more generalized situation described in *Itel*, and given this Court's very recent decision applying the *Wardair* rule to the *Itel* facts, there is no need for this Court to reconsider the California Supreme Court's proper application of *Wardair*. The California court has not fashioned a new test of its own—it has simply applied the *Wardair* test in a manner which is totally consistent with this Court's February 1993 application of *Wardair* in *Itel*.[7]

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[7] The decision in *Itel* concluded its Commerce Clause holding by quoting from *Wardair*: " 'It would turn dormant Commerce Clause analysis entirely upside down to apply it where the Federal Government has acted, and to apply it in such a way as to *reverse* the policy that the Federal Government has elected to follow.' " 113 S.Ct. at 1105 (emphasis in original). Taxpayer/petitioner may try to argue that *Itel*'s quotation from *Wardair* somehow does not mean what the same clear language meant in *Wardair*, and that the essence of the *Itel* holding somehow rests on dormant Commerce Clause principles. This Court's Commerce Clause discussion in *Itel* does include analysis of dormant Commerce Clause elements, with references to *Japan Line, Ltd.* v. *County of Los Angeles*, 441 U.S. 434 (1979) and *Container*, *supra*. However, once the last, "one-voice," element was reached, this Court focussed on the possibility that Congress had acquiesced in the type of state tax which was at issue. Realizing, under *Wardair*, that such acquiescence would be determinative of the Commerce Clause issue, this Court noted that within the *Itel* context the Federal Government had acted on the subject matter (state taxation of cargo containers and their use) without proscribing the type of state tax which was directly at issue in *Itel*. Under those circumstances (and utilizing

II

THE DETERMINATION OF THE FOREIGN COMMERCE CLAUSE ISSUE IN THIS CASE PRECLUDES ANY FOREIGN AFFAIRS PREEMPTION ISSUE.

A foreign affairs pre-emption issue simply cannot be determinative in this foreign commerce context. It is clear that at the heart of the California Supreme Court's opinion is an issue pertaining directly to the Foreign Commerce Clause. It is undisputed that the Constitution gives to Congress alone the power "[t]o regulate commerce with foreign nations. . . . " U.S. Const. art. I, § 8(3). If, as the California Supreme Court has held, proper application of the *Wardair* rule in this case confirms that federal law pertaining to foreign commerce contains permission for the states' use of WWCR, then no contrary foreign affairs aspirations of the Executive Branch could eclipse

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the *Wardair* approach), this Court held in *Itel* that "the most rational inference to be drawn" is that the Tennessee Tax "is permitted." 113 S.Ct. at 1105. This is not a dormant Commerce Clause holding. If the Tennessee tax in *Itel* had *not* passed the tests of all of the dormant Commerce Clause elements which were considered, the *Itel* Commerce Clause result still would have been the same. This Court's reaffirmation of the *Wardair* holding and approach makes clear that the Tennessee tax still would have been upheld, because Congress, in *non*-dormant actions, impliedly permitted such a state tax. Any other result " 'would turn dormant Commerce Clause analysis entirely upside down.' " 113 S.Ct. at 1105. Furthermore, any claim by petitioner Barclays that *Itel* does not apply *Wardair* to reach its Commerce Clause holding based upon implied (rather than express) permission is refuted by the *Itel* dissenting justice's recognition (and criticism) that the majority "find[s] congressional authorization for the tax in congressional silence . . . . " 113 S.Ct. at 1110.

that permission. The Executive Branch's power in the field of foreign relations, " 'like every other governmental power, must be exercised in subordination to the applicable provisions of the Constitution.' " *Dames & Moore* v. *Regan*, 453 U.S. 654, 661 (1981), quoting *United States* v. *Curtiss-Wright Export Corp.*, 299 U.S. 304, 319-20 (1936).

But what of authorities such as *Hines* v. *Davidowitz*, 312 U.S. 52 (1941), and *Zschernig* v. *Miller*, 389 U.S. 429 (1968)? Barclays relies on these cases as barring any state act which has a direct impact upon foreign relations and which may well adversely affect the power of the central government to deal with foreign affairs issues. The answer in this case must be given in the foreign commerce context. If Congress has acted so as to permit state action in a foreign commerce context, no further authorization is needed, even though foreign relations necessarily are also involved. See *Wardair*, 477 U.S. at 12-13; see also *United States* v. *Guy W. Capps, Inc.*, 204 F.2d 655 (4th Cir. 1953), *aff'd on other grds.*, 348 U.S. 296 (1955).

Alternatively, in a dormant Foreign Commerce Clause context where no congressional acquiescence or prohibition is present, the *Container* decision teaches that a state tax at variance with the federal tax approach and affecting foreign commerce will violate the Foreign Commerce Clause if it " 'may impair federal uniformity in an area where federal uniformity is essential' . . . and 'prevents the Federal Government from "speaking with one voice" in international trade. . . . ' " 463 U.S. at 194. In reaching its Foreign Commerce Clause holding, the *Container* decision contains many references to "foreign affairs," "foreign relations," and "foreign policy" (see 463 U.S. at 189, 194, 195, 196, 197); it rejected the dissent's

position that California's application of WWCR was "an intrusion on national policy in foreign affairs that is not permitted by the Constitution." 463 U.S. at 206 (dissent). Thus, under *Container*, a dormant Foreign Commerce Clause holding in favor of WWCR includes consideration and determination of foreign affairs issues, leaving no room for any determination that the federal government's foreign affairs powers bar the application of WWCR to that taxpayer. This is consistent with the rule that the Congress and the President share authority over foreign affairs. See *Container*, 463 U.S. at 196; *Zschernig* v. *Miller*, 389 U.S. 429, 432 (1968). If a state tax affecting foreign commerce is valid either by way of congressional authorization or under the dormant Foreign Commerce Clause tests (which include the balancing of foreign policy considerations), it cannot be unconstitutional on the basis of infringement upon foreign affairs.

Application of Barclays' foreign affairs preemption argument in this case would also rewrite the treaty powers provisions of the United States Constitution. Congress, through the Senate's actions on the many bilateral income tax treaties, and through the Senate's action on article 9(4) of the US/UK Treaty, has taken affirmative action which allows the states to tax unfettered by separate accounting restrictions placed on the national government and unfettered by proposed article 9(4), and has therefore impliedly authorized state use of WWCR. This Court cannot construe the Executive Branch's foreign policy aspirations as authoritative federal policy without disabling not only Congress, but also the Constitution, which requires that treaties can become law only upon ratification by two-thirds vote of the Senate. U.S. Const. art. II, § 2 (App. A hereto.) By rejecting the Executive Branch's 1970's aspirations which were given voice in proposed article 9(4) of the US/UK Treaty, Congress' implied acquiescence in the state use of WWCR has become a part of the "supreme law of the land" (U.S. Const. art. VI(2)); it cannot now be voided merely by relabeling the Executive Branch's thwarted aspirations as "foreign policy."

III

EVEN IF A DORMANT COMMERCE CLAUSE ANALYSIS WERE TO BE APPLIED, THERE WOULD BE NO VIOLATION OF THE DISCRIMINATION ELEMENT OF SUCH A DORMANT ANALYSIS.

As properly held by the California Supreme Court, under *Wardair*, once it is determined that Congress has acquiesced in the type of state taxation which is being challenged, there is absolutely no need for the courts to engage in any *dormant* Commerce Clause analysis. See above at p. 17.[8] Therefore, in this case there is no

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[8] Given the Commerce Clause holding of the California Supreme Court, the only issue it remanded to the Court of Appeal was the Due Process Clause issue. After specifically noting that the Court of Appeal's first decision had not directly ruled upon the discrimination element in its dormant Commerce Clause analysis, the California Supreme Court ordered the remand so that the Court of Appeal could consider the merits of the due process issue "free of the view that a dormant foreign commerce clause analysis is appropriate in the circumstances present here." C-39. In spite of this guidance, the Court of Appeal engaged in unnecessary dormant Commerce Clause analysis, but it reached the correct conclusion that the

necessity for this Court to review petitioner Barclays' claim that California's application of WWCR resulted in a violation of the discrimination element of the dormant Commerce Clause analysis.[9]

Although its dormant Commerce Clause analysis was not necessary, the California Court of Appeal reached the correct conclusion as to the discrimination element. It correctly noted that under California law both foreign-based and domestic-based unitary groups "are treated the same—they face the same tax rate and must furnish the same kind of information." D-12. The fact that domestic groups, but not foreign-based groups, might also have to supply the same type of information to comply with United States tax laws does not inject discrimination into

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discrimination element of such an analysis would be satisfied here. D-6 to D-14.

[9] Barclays bases its discrimination argument on an allegation that it must either (1) incur enormous costs of setting up an additional accounting system solely for the purpose of properly preparing its California tax returns or (2) forgo tax benefits. The California Court of Appeal clearly has held that California law does not require any costly additional accounting system (furthermore, it requires nothing of Barclays that is not also required of domestic-based unitary businesses) (D-13 to D-25). As to tax benefits, the record in this case contains uncontested instances of the availability of tax benefits (such as depreciation and bad debts) within the California system's use of reasonable approximations and materiality. RT 1467-69, 1471-72. In any event, if the use of reasonable approximations somehow meant that tax benefits would become unavailable, the federal tax law's arm's-length method would fail in the same manner, for, as taxpayers' own expert witness testified, application of the federal system also depends on the use of reasonable approximations. RT 1270; see also 26 C.F.R. § 1.805-5(a)(4)(iv)(b).

the evenhanded California tax requirements. D-12 to D-14.

The Court of Appeal correctly relied upon this Court's recent decision in *Kraft General Foods* v. *Iowa Dept. of Revenue*, ___ U.S. ___, 112 S.Ct. 2365 (1992). In *Kraft* this Court held that an Iowa tax law discriminated against foreign commerce because "Iowa imposes a burden on foreign subsidiaries that it does not impose on domestic subsidiaries." *Id.* at 2371 (footnote omitted). This Court also noted that if a state's tax system "does not favor business activity in the United States generally over business activity abroad[,] . . . this would indeed suggest that the statute does not discriminate against foreign commerce." *Id.* at 2370. As recognized by the California Court of Appeal, California applies exactly the *same* tax and information requirements to all businesses, whether they have foreign connections or solely domestic connections. The fact that the Barclays group does not have to meet certain United States *federal* tax accounting requirements which domestic groups must fulfill separately from the California requirements, does not render California's law discriminatory as to members of the Barclays group. See *Cotton Petroleum Corp.* v. *New Mexico*, 490 U.S. 163, 189 (1989), where this Court held that New Mexico's taxes were not unconstitutionally discriminatory:

> "The burdensome consequence is entirely attributable to the fact that the [taxable activities] are located in an area where two governmental entities share jurisdiction. . . . [T]he New Mexico

> taxes are administered in an evenhanded manner and are imposed at a uniform rate throughout the State . . . . "[10]

In any event, once it is determined that a state tax is not discriminatory on its face, the discrimination element of the dormant Commerce Clause analysis is satisfied if the tax is fairly apportioned. *Trinova Corp.* v. *Michigan Dept. of Treasury*, ___ U.S. ___, 111 S.Ct. 818, 835 (1991). In this case, consistent with this Court's holding in *Container* that the California tax system provides for fair apportionment of taxable income (463 U.S. at 180-84; see also above at pages 7-8), the Barclays taxpayers have stipulated that they are not challenging the fairness of California's apportionment of income under WWCR. RT 1551. Under these circumstances, no discrimination is present for purposes of dormant Commerce Clause analysis.

IV

CALIFORNIA'S APPLICATION OF WORLDWIDE COMBINED REPORTING TO THE BARCLAYS TAXPAYERS DID NOT VIOLATE DUE PROCESS.

After holding that Congress had exercised its Commerce Clause powers to permit California's use of WWCR, and having thus determined that no dormant Commerce Clause analysis could alter that permission,

[10] The California Court of Appeal correctly distinguished the *Barclays* context from such cases as *Hunt* v. *Washington State Apple Advertising Comm'n*, 432 U.S. 333 (1977), on the basis that in *Barclays* foreign-based multinationals and domestic-based multinationals "must both furnish the same kind of information." D-11, n. 4.

the California Supreme Court remanded the case to the California Court of Appeal for determination of the due process issues. C-38 to C-39. The Court of Appeal then confirmed that California law provides for (1) the avoidance of oppressive costs of compliance through the use of reasonable approximations and the principle of materiality (D-13 to D-14, D-20 to D-21, D-23 to D-24) and (2) judicial review of any claimed abuses of discretion by the taxing agency in the application of this procedure (D-21, D-23). On the basis of its construction of California law, the Court of Appeal held that there was no violation of due process in this case. D-27. The California Supreme Court denied Barclays' petition for review of this construction and holding. E-1.

This Court has held that it is not free to overturn the California Court of Appeal's constructions of California state law when the California Supreme Court has denied review of the case. *Hicks* v. *Feiock*, 485 U.S. 624, 629-30 (1988). Nevertheless, petitioner Barclays raises an empty claim that the challenged California regulation is not explicit enough, that "enforcement rests in the effectively standardless discretion of the administering agency." Pet. 30. Given the California court's carefully circumscribed construction of regulation 25137-6 (Pet. App. J),[11] given

[11] "[T]he Board must consider the cost and effort of producing WWCR information in deciding whether to accept reasonable approximations, and that consideration is to use regularly-maintained or other readily-accessible corporate documents as the cost guideline." D-21. "[T]he Board's discretion regarding reasonable approximations is circumscribed and guided by our interpretation of section 25137-6(e)(1)'s mandatory consideration of cost and effort." D-23.

this Court's established endorsement of the standard of "reasonable" as providing sufficient and appropriate guidance in the due process area,[12] and given the total lack of any showing that there was any abuse of discretion in the final administrative result in this case, petitioner's due process argument would necessarily fail on the merits. No due process ground of any substance exists for review in this Court.

CONCLUSION

For the reasons given above, it is respectfully submitted that the petition for writ of certiorari should be denied.

Dated: April 23, 1993.

Respectfully submitted,

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[12] See D-22, citing, *inter alia, United States* v. *Ragen*, 314 U.S. 513, 522-24 (1942).

APPENDIX A

CONSTITUTIONAL AND STATUTORY PROVISIONS

UNITED STATES CONSTITUTION

Article II, section 2, clause 2 (in part):

> [The President] shall have power, by and with the advice and consent of the Senate, to make treaties, provided two-thirds of the Senators present concur. . . .

CALIFORNIA REVENUE AND TAXATION CODE

Section 25110 (water's-edge election):

(a) Notwithstanding Section 25101, a qualified taxpayer, as defined in paragraph (2) of subdivision (b) which is subject to the tax imposed under this part, may elect to determine its income derived from or attributable to sources within this state pursuant to a water's-edge election in accordance with the provisions of this part, as modified by this article. A taxpayer which makes a water's-edge election shall take into account the income and apportionment factors of the following affiliated entities only:

(1) Affiliated banks or corporations which are eligible to be included in a federal consolidated return as described in Sections 1501 to 1505, inclusive, of the Internal Revenue Code, other than corporations making an election under Section 936 of the Internal Revenue Code.

(2) Domestic international sales corporations, as described in Sections 991 to 994, inclusive, of the Internal Revenue Code and foreign sales corporations as

described in Sections 921 to 927, inclusive, of the Internal Revenue Code.

(3) Any corporation, regardless of the place where it is incorporated if the average of its property, payroll, and sales factors within the United Sates is 20 percent or more.

(4) Banks and corporations which are incorporated in the United States, excluding corporations making an election pursuant to Sections 931 to 936, inclusive, of the Internal Revenue Code, of which more than 50 percent of their stock is controlled directly or indirectly by the same interests, which are not included in paragraph (1).

(5) A bank or corporation which is not described in paragraphs (1) to (4), inclusive, or paragraph (6), but only to the extent of its income derived from or attributable to sources within the United States and its factors assignable to a location within the United States in accordance with paragraph (3) of subdivision (b). Income of such a bank or corporation derived from or attributable to sources within the United States as determined by federal income tax laws shall be limited to and determined from the books of account maintained by the bank or corporation with respect to its activities conducted within the United States.

(6) Export trade corporations, as described in Sections 970 to 972, inclusive, of the Internal Revenue Code.

(7) Any affiliated bank or corporation which is a "controlled foreign corporation", as defined in Section 957 of the Internal Revenue Code, if all or part of the income of that affiliate is defined in Section 952 of Subpart F of the

Internal Revenue Code ("Subpart F income"). The income and apportionment factors of any affiliate to be included under this paragraph shall be determined by multiplying the income of and apportionment factors of that affiliate without application of this paragraph by a fraction (not to exceed one), the numerator of which is the "Subpart F income", of that bank or corporation for that income year and the denominator of which is the "earnings and profits" of that bank or corporation for that income year, as defined in Section 964 of the Internal Revenue Code.

(8) (A) The income and factors of the above-enumerated banks and corporations shall be taken into account only if the income and factors would have been taken into account under Section 25101 if this section had not been enacted.

(B) The income and factors of a bank or corporation which is not described in paragraphs (1) to (4), inclusive, and (6) and which is an electing taxpayer under this subdivision shall be taken into account in determining its income only to the extent set forth in paragraph (5).

(b) For purpose of this article and Section 24411:

(1) An "Affiliated bank or corporation" means a bank or corporation which is related to a bank or corporation, required to file under this part, because of any of the following:

(A) It owns directly or indirectly more than 50 percent of the voting stock of the bank or a corporation required to file under this part.

(b) More than 50 percent of its voting stock is owned directly or indirectly by a bank or corporation required to file under this part.

(c) More than 50 percent of voting stock of both it and the bank or corporation required to file under this part is owned or controlled directly or indirectly by any bank or person (as defined in Section 7701(a)(1) of the Internal Revenue Code).

(2) A "qualified taxpayer" means a bank or corporation which does both of the following:

(A) Files with the state tax return on which the water's-edge election is made a consent to the taking of depositions at the time and place most reasonably convenient to all parties from key domestic corporation individuals and to the acceptance of subpoenas duces tecum requiring reasonable production of documents to the Franchise Tax Board as provided in Section 26423 or by the State Board of Equalization as provided in Title 18, California Code of Regulations, Section 5005, or by the courts of this state as provided in Chapter 2 (commencing with Section 1985) of Title 3 of Part 4 of, and Section 2025 of, the Code of Civil Procedure. The consent relates to issues of jurisdiction and service and does not waive any defenses a taxpayer may otherwise have. The consent shall remain in effect so long as the water's-edge election is in effect and shall be limited to providing that information necessary to review or to adjust income or deductions in a manner authorized under Sections 482, 861, Subpart F of Part III of Subchapter N, or similar provisions of the Internal Revenue Code, together with the regulations adopted pursuant to those provisions, and for the conduct of an investigation with

respect to any unitary business in which the taxpayer may be involved.

(B) Agrees that for purposes of this article, dividends, received by any bank or corporation whose income and apportionment factors are taken into account pursuant to subdivision (a) from either of the following are functionally related dividends and shall be presumed to be business income:

(i) A bank or corporation of which more than 50 percent of the voting stock is owned, directly or indirectly, by members of the unitary group and which is engaged in the same general line of business.

(ii) Any bank or corporation which is either a significant source of supply for the unitary business or a significant purchaser of the output of the unitary business, or which sells a significant part of its output or obtains a significant part of its raw materials or input from the unitary business. "Significant," as used in this subparagraph, means an amount of 15 percent or more of either input or output.

All other dividends shall be classified as business or nonbusiness income without regard to this subparagraph.

(3) The definitions and locations of property, payroll, and sales shall be determined under the laws and regulations which set forth the apportionment formulas used by the individual states to assign net income subject to taxes on or measured by net income in that state. If a state does not impose a tax on or measured by net income or does

not have laws or regulations with respect to the assignment of property, payroll, and sales, the laws and regulations provided in Article 2 (commencing with Section 25120) shall apply.

Sales shall be considered to be made to a state only if the bank or corporation making the sale may otherwise be subject to a tax on or measured by net income under the Constitution or laws of the United States, and shall not include sales made to a bank or corporation whose income and apportionment factors are taken into account pursuant to subdivision (a) in determining the amount of income of the taxpayer derived from or attributable to sources within this state.

(4) "The United States" means the 50 states of the United States and the District of Columbia.

(c) All references in this part to income determined pursuant to Section 25101 shall also mean income determined pursuant to this section.

No. 92-1384

In the Supreme Court

OF THE

United States

October Term, 1992

Barclays Bank PLC
Petitioner,
vs.
Franchise Tax Board,
An Agency of the State of California
Respondent.

ON PETITION FOR A WRIT OF CERTIORARI TO THE COURT OF APPEAL OF THE STATE OF CALIFORNIA IN AND FOR THE THIRD APPELLATE DISTRICT

PETITIONER'S REPLY BRIEF

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No. 92-1384

In the Supreme Court

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OCTOBER TERM, 1992

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ON PETITION FOR A WRIT OF CERTIORARI TO THE COURT OF APPEAL OF THE STATE OF CALIFORNIA IN AND FOR THE THIRD APPELLATE DISTRICT

PETITIONER'S REPLY BRIEF

INTRODUCTION

Respondent admits that this case squarely presents the issue which this Court expressly reserved in *Container Corp. of America v. Franchise Tax Board*, 463 U.S. 159, 189 n. 26, 195 n. 32 (1983). Respondent's Brief in Opposition (hereafter "R.B.") at 10. Respondent does not deny, nor can it, that this issue is one of great national and international importance. In fact, respondent essentially admits that worldwide combined reporting "has a direct impact upon foreign relations" and "may well adversely affect the power of the central government to deal with foreign affairs issues." R.B. at 21. The numerous amici curiae briefs in support of this petition, including those from the United Kingdom and from the Member States of the European Communities and the governments of Australia, Austria, Canada, Finland, Japan, Norway, Sweden and Switzerland, demonstrate that this reserved issue remains closely watched, and, as we write today, the United Kingdom is discussing what further steps it may take. The stakes

are high — the unravelling of over 60 years of international cooperation on an agreed upon standard for division of income among nations.

Respondent contends nevertheless that review should be denied because this Court's decisions in *Wardair Canada, Inc. v. Florida Department of Revenue*, 477 U.S. 1 (1986), and *Itel Containers International Corp. v. Huddleston*, ____ U.S. ____, 113 S. Ct. 1095 (1993), allegedly support the decision of the California Supreme Court. On the contrary, the California court's decision represents a gross misreading of this Court's decisions and in fact stands commerce clause jurisprudence on its head.

These issues will not go away. As commerce becomes global, more and more questions before the Court on the oft recurring issue of the states' rights to burden commerce are now arising in the context of foreign commerce. Failure to resolve the important issues presented herein will only stimulate further aggressive and unconstitutional taxation not just by California but by the numerous other states which are already contemplating alternative systems to tax international business. This case is uniquely well positioned as a vehicle for such resolution.

For these reasons, this Court should grant certiorari.

ARGUMENT

I. THE ISSUES PRESENTED HERE ARE AND CONTINUE TO BE MATTERS OF GREAT NATIONAL AND INTERNATIONAL SIGNIFICANCE.

At the outset it should be emphasized that the issues in this case remain ones of great and ongoing concern. Respondent attempts to suggest in various ways that the issues have been resolved. Respondent is wrong.[1]

[1]For example, respondent mentions the 1986 California water's edge elective legislation (effective in 1988), but respondent markedly omits the fact that taxpayers which elect must pay annual fees for this "privilege" (in addition to the tax) aggregating $60 million to $100 million per year. Such legislation also has other burdens and penalties. Worldwide combined reporting still remains as the basic California system. The United Kingdom, the United States and the European Communities have stated that the legislation does not resolve the important issues in this case.

This Court has stated that the threat of offending our foreign trading partners and leading them to retaliation constitutes the most obvious example of foreign policy implication of a state tax. *Container*, 463 U.S. at 194. This case involves actual retaliation, as well as numerous and ongoing threats, not just by the United Kingdom but by the United States' major trading partners.

At stake here is the preservation of the internationally accepted standard for the division of income among nations for tax purposes, the arm's-length separate entity accounting method. Respondent does not deny that this is the international standard, and this Court has so found. *Container*, 463 U.S. at 184. Respondent does not deny that worldwide combined reporting is an incompatible and conflicting system. As the amici in this case have stated, nations fear the loss of the uniform standard which has provided the framework for resolutions of difficult and sensitive issues for 60 years. If California's method is allowed to stand unchallenged, its presence as a second and competing system can only result in continued turmoil and controversy.

This issue is not only of importance to governments. The amicus briefs from both foreign and domestic business interests show that the issues affect both domestic owned and foreign owned multinational businesses and create ongoing and recurring problems. As Amici National Foreign Trade Council, Inc. et al. state, the issue has enormous practical importance for the United States' economy:

> Allowing the California decision to stand could well provoke a cascade of international retaliatory actions, the consequences of which for the U.S. economy, for U.S.-owned foreign businesses, and for the global economy as a whole are likely to be extremely damaging. At a minimum, government-imposed economic counter-measures will almost certainly skew international investment decisions, disrupting the flow of foreign capital into the United States and reducing the attractiveness of foreign investment for U.S. businesses.

Brief for National Foreign Trade Council, Inc. et al., as Amici Curiae in Support of Petitioner at 13. In addition to the National

Foreign Trade Council, Inc., amici on this brief in support of petitioner include the National Association of Manufacturers, the Chamber of Commerce of the United States of America, the Business Roundtable, the United States Council for International Business, the Emergency Committee for American Trade, the American Petroleum Institute, the Chemical Manufacturers Association, the Financial Executives Institute, the Tax Council, and the California Chamber of Commerce. To similar effect, the Committee on State Taxation states:

> This Foreign Commerce Clause issue is of such importance to international trade and the retaliatory threat to domestic corporations so immediate that it must not be left unanswered by this Court any longer.

Brief of the Committee on State Taxation as Amicus Curiae in Support of Petitioner at 9. Amici curiae for foreign business express similar concerns.

All amici express dismay over the long delay in resolving this issue and fears over the effect of further delay.

Respondent implies that the United Kingdom is perhaps unjustified in enacting retaliatory legislation and seeking resolution of this issue. Respondent states that such retaliatory legislation has not been implemented and that implementation might violate the United States/United Kingdom tax treaty. R.B. at 6. Respondent ignores the fact that every major trading partner of the United States has joined the United Kingdom in protests, complaints and diplomatic action. As this brief is written, the United Kingdom is discussing what further steps it may take, including reopening the treaty. The United States itself in its amicus curiae brief filed in the California Supreme Court answers the issue of justification:

> Appellant [now respondent] also argues that the conduct of foreign affairs is not significantly implicated because the retaliation by Great Britain is not justified under United States law. It is submitted that the conduct of foreign affairs is necessarily determined not by whether a foreign country's actions are justified under our law as opposed to foreign law but rather whether there is a dispute with a foreign country and what is the most efficient and beneficial manner of resolving that dispute. Accordingly, whether or not Great Britain's retaliatory legislation is or is not justified under our law is of no great moment. The fact remains that a potentially serious dispute exists with Great Britain, and retaliatory legislation by Great Britain is in place, both of which can have adverse effects on United States' foreign commercial relations.

Brief Amicus Curiae of the United States in Support of Plaintiffs and Respondents, App. H at 41 n.18. Respondent also suggests that the United Kingdom had somehow bargained away its right to complain about California's method. R.B. at 5-6 and 15. Respondent misstates the record. The United Kingdom did not ratify the treaty only after "exact[ing] other federal tax concessions from the United States." R.B. at 15. The United Kingdom made it quite clear at the time of the ratification that it expected the problem of worldwide combined reporting to be solved. App. A at 44, ¶ 32c (exhibit 32C, Demarche 51); App. A at 72, ¶ 37h (exhibit 37H, p. 80). The efforts of the U.S. federal government subsequent to the ratification of the treaty clearly indicate that neither the United States nor the United Kingdom saw the treaty as any final resolution on the question of the states' use of worldwide combined reporting. Reporter's Transcript ("R.T.") at 417-18; exhibits 32C, 34.

II. THE DECISION OF THE CALIFORNIA SUPREME COURT CONFLICTS WITH THIS COURT'S EXISTING DECISIONS.

Respondent's essential contention is that this Court need not review this case because the California Supreme Court decision is, allegedly, a correct application of existing precedent. However, respondent's "existing precedent" is *Wardair* and *Itel*, neither of which stands for the propositions advanced by either the California court or respondent, and both of which actually support petitioner.

In actuality, the California Supreme Court has ignored existing precedent. That court specifically rejected this Court's dormant commerce clause precedents under *Japan Line, Ltd. v. County of Los Angeles*, 441 U.S. 434 (1979) and *Container* on the ground that *Wardair* "reoriented" commerce clause jurisprudence. It is for this Court, not the California courts, to engage in any such

"reorientation" which in effect overrules this Court's *Container* case.[2] *Rodriguez de Quijas v. Shearson/American Express, Inc.*, 490 U.S. 477, 484 (1989).

Further, neither the California court nor respondent addresses the conflict between the California Supreme Court's decision and other existing precedent such as this Court's longstanding requirement, confirmed both before and after *Wardair*, that the congressional consent needed to remove a state tax from commerce clause scrutiny must be specific, unambiguous, and based on an affirmative text. *See, e.g., Wyoming v. Oklahoma*, ____ U.S. ____, 112 S. Ct. 789 (1992).[3]

In truth, *Wardair* can hardly be said to constitute precedent for the California court's new approach to determine whether Congress has exercised its power over foreign commerce. *Wardair* involved an affirmative congressional text. This case does not. There is a world of difference between the specific legislation of the Chicago Convention in *Wardair* (which addressed state taxes on aviation fuel and specifically prohibited some state taxes on such fuel, but not the Florida tax at issue there) and the ratification here of the United States/United Kingdom tax treaty without a provision barring states' use of worldwide combined reporting. The Chicago Convention represented an international consensus on the solution of the problem: a partial prohibition. In contrast, here a majority of the Senate voted twice to ban worldwide combined reporting but a minority of the Senate blocked that clear majority from achieving the necessary two

[2] Respondent never explains why this Court's discussion of California worldwide combined reporting subsequent to *Wardair* refers to both *Japan Line* and *Container* as the controlling precedents without mentioning *Wardair* or "reorientation." *See Franchise Tax Bd. v. Alcan Aluminium, Ltd.*, 493 U.S. 331, 334-35 (1990).

[3] Respondent chides the California Court of Appeal for discussing the discrimination issue on remand (R.B. at 23 n.8), but this is a sterling example of why the California Supreme Court's approach in the absence of enactment is unworkable. Without a congressional text, the Court of Appeal had no way to tell whether Congress' alleged "silent acquiescence" in worldwide combined reporting extended to the imposition of discriminatory compliance burdens.

thirds vote on the treaty as a whole. This absence of affirmative legislation can hardly be said to represent a consensus of the Senate approving states' use of worldwide combined reporting.

Indeed, this Court has already determined that Congress has not acted, either to proscribe or permit the use of worldwide combined reporting by the states. *Container*, 463 U.S. at 194, 196. This Court has already addressed the United States/United Kingdom tax treaty and the other items upon which the California court relied as evidence of "acquiescence,"[4] and has held that none of these constitute either "explicit" congressional action or even "indications" of congressional intent. *Id.* There must be some enactment addressing the issue. No such enactment evidencing Congress' exercise of its power exists in this case.

Respondent's reliance on *Itel* is similarly misplaced. In *Itel* this Court clearly *followed* the dormant commerce clause analysis used in both *Japan Line* and *Container*. The Tennessee sales tax neither created a risk of international multiple taxation under the first prong of the *Japan Line* test,[5] nor infringed on government's ability to speak with one voice when regulating commercial relations with nations, the second of the *Japan Line/Container* dormant commerce clause tests.[6]

[4] All of which were before this Court in *Container*. *See* Brief for Nestlé Holdings Inc. et al., as Amici Curiae in Support of Petitioner for Writ of Certiorari at 19.

[5] Tennessee gives a credit against its own tax for taxes paid to another jurisdiction in the same transaction, thus eliminating risk of multiple tax. In contrast, California gives no credit. California does not even give a deduction.

[6] This Court noted that the Tennessee tax does not fall within the class of state taxes specifically prohibited by the various container conventions. The United States, appearing as amicus, stated that the Tennessee tax did not conflict with international custom. Respondent twice mentions the dissent of Justice Blackmun which refers to, among other things, the majority's "inference" of congressional consent. However, in *Itel*, as in *Wardair*, there is congressional enactment and hence text dealing with some state taxes. Further, the majority clearly used a dormant commerce clause analysis, it did not reject such analysis as did the California court. Justice Scalia's partial concurrence in *Itel* confirms that this Court is applying such dormant commerce clause analysis.

III. THIS COURT SHOULD ALSO GRANT CERTIORARI ON THE DISCRIMINATION AND DUE PROCESS ISSUES.

This Court should also grant certiorari with respect to the discrimination and due process issues.

With respect to the discrimination issue, respondent essentially ignores this Court's decision in *Hunt v. Washington State Apple Advertising Commission*, 432 U.S. 333 (1977), which struck down an allegedly even-handed grading system that deprived Washington apple growers of the use of their own established system and, by requiring alteration of their packages to conform to the new system, increased the cost of those already far from the market. A presumably "neutral" rule is no defense where, as here, identifiable groups of taxpayers are differently and adversely affected by the rule's application.[7] As this Court said in *Fort Gratiot Sanitary Landfill, Inc. v. Michigan Department of Natural Resources*, ____ U.S. ____, 112 S. Ct. 2019, 2025 (1992), quoting with approval from *Brimmer v. Rebman*, 138 U.S. 78, 82-83 (1891):

> [T]his statute [cannot] be brought into harmony with the Constitution by the circumstance that it purports to apply alike to the citizens of all the States, including Virginia; for "a burden imposed by a State upon interstate commerce is not to be sustained simply because the statute imposing it applies alike to the people of all the States, including the people of the State enacting such statute."

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[7]Respondent also seeks to downplay the costs imposed by worldwide combined reporting. R.B. at 3 n.1. After initially affirming the findings of the trial court, on the basis of substantial evidence, that the cost to set up and maintain the system in compliance with the California regulations was huge ($5 million to set up and $2 million per year to maintain), the Court of Appeal on remand, in its discussion on due process, mistakenly referred to the incorrect filing for BBI as evidence of overall burden. BBI's returns in the early 1970s, filed without including either Barclays Bank of California or Barclays Bank Limited and its direct subsidiaries other than BBI, were not in compliance, were rejected by respondent and therefore have no relevance here.

There can be no dispute about the disparate impact of the California method between foreign and domestic business.[8] Foreign multinationals clearly bear a burden in responding to respondent's system that domestic multinationals or interstate businesses do not bear.[9] *Kraft Gen. Foods, Inc. v. Iowa Dep't of Revenue and Fin.*, ____ U.S. ____, 112 S. Ct. 2365 (1992); *see also Japan Line*, 441 U.S. 434.

Similarly, Respondent attempts to sidestep the due process issue by characterizing it as a matter of construction of California law. R.B. at 27. Respondent misstates the nature of petitioner's argument. Petitioner does not dispute here the California court's construction, but rather submits that the law, as construed, still violates due process.

As construed, the Regulation's "relief" provisions still give no meaningful guidance on what the Franchise Tax Board must accept. Taxpayers still must negotiate the "what" under threat of penalty. At best, such provisions result in a filing under a different regime (financial accounting information as opposed to tax accounting information). This often produces higher tax and cer-

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[8]Foreign taxpayers also face loss of tax benefits. *See New Energy Co. v. Limbach*, 486 U.S. 269 (1988). Contrary to respondent's misstatement of the record, its staff stated that they would deny tax benefits without proper records. R.T. at 349-53, 355-57, 379-80.

[9]Respondent's reliance on *Cotton Petroleum Corp. v. New Mexico*, 490 U.S. 163 (1989) is misplaced. In that case, this Court held that both the State of New Mexico and the Apache Indian Tribe (as well as the United States) had concurrent jurisdiction to tax oil wells located on the reservation in the State of New Mexico. There was no claim in that case that the state tax imposed severe or discriminatory compliance burdens. Nor were any of those jurisdictions asking worldwide information about any operations. Further, respondent's reliance on *Trinova Corp. v. Michigan Department of Treasury*, ____ U.S. ____, 111 S. Ct. 818 (1991) is misplaced. That case did not involve discriminatory compliance burdens, and the taxpayer in that case made no claims of discrimination other than vague allegations. Here there is actual discrimination.

tainly inconsistent tax, itself a form of discrimination.[10] In short, the efforts of the California court to "fix" these provisions do not cure their discriminatory and arbitrary nature. They remain violative of due process.

CONCLUSION

These issues are important. They will not go away. Their resolution affects fundamental constitutional jurisprudence. Failure to resolve these issues will open the floodgates of diverse state schemes to tax international business, each of which will embroil this Court in further controversies if this Court does not reaffirm its longstanding dormant commerce clause principles. This Court should grant certiorari.

DATE: April 28, 1993

Respectfully submitted,

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[10]As one witness stated, what was acceptable one year might not be acceptable the next. R.T. at 934-38. Further, denial of tax benefits will result in higher cost.

(12)

No. 92-1384

In the Supreme Court of the United States

OCTOBER TERM, 1993

BARCLAYS BANK PLC, PETITIONER

v.

FRANCHISE TAX BOARD OF CALIFORNIA

ON PETITION FOR A WRIT OF CERTIORARI TO THE COURT OF APPEAL OF CALIFORNIA, THIRD APPELLATE DISTRICT

BRIEF FOR THE UNITED STATES AS AMICUS CURIAE

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QUESTION ADDRESSED BY THE UNITED STATES

Whether, as applied (i) to a domestic corporation that has a foreign parent or (ii) to a foreign corporation that has a foreign parent or foreign subsidiaries, California's use of the worldwide formula apportionment method to allocate income for tax purposes violates the Commerce Clause of the Constitution.

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ON PETITION FOR A WRIT OF CERTIORARI TO THE COURT OF APPEAL OF CALIFORNIA, THIRD APPELLATE DISTRICT

BRIEF FOR THE UNITED STATES AS AMICUS CURIAE

This brief is submitted in response to the Court's order inviting the Solicitor General to express the views of the United States.

STATEMENT

1. Different methods have been used to identify and allocate among taxing jurisdictions the income received by multinational corporations. The method employed by the United States is known as the "separate accounting" or "arm's length" method. This method generally treats each corporation as a distinct tax unit, doing business with every other corporation (including its parent, subsidiaries or affiliates) on an arm's length basis. The separate accounting method of taxation is employed in the Internal

Revenue Code and in the many bilateral tax treaties to which the United States is a party (Pet. App. H43).[1] The separate accounting method is also employed by most other nations for both domestic and international purposes.[2]

Another method of allocating corporate income among taxing jurisdictions is the "worldwide combined reporting" method that was, with respect to the tax years involved in this case, used by California and a few other States.[3] Under

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[1] There are, of course, distinctions and refinements employed in the Internal Revenue Code to forestall potential abuses of the separate accounting method. See, *e.g.*, 26 U.S.C. 482, 551-558, 951-964.

[2] The international practice is described in the letter to Governor Deukmejian of California, dated January 30, 1986, from Secretary of State George P. Shultz (Pet. App. H43-H45). The arm's length method is the primary method for allocating income internationally. Other than in a few States of the United States, the worldwide combined reporting method has not been used at the national or subnational level by the United States or any of its major trading partners.

[3] Under legislation enacted in 1986 (effective in 1988), California provided corporations with a "water's edge" election to avoid application of worldwide formulary apportionment to the income of their foreign affiliates and parents. See Cal. Rev. & Tax. Code § 25110 (West 1992); Pet. App. B4 n.2. In general, the "water's edge" method permits a taxpayer to report its earnings separately from the earnings of its foreign parents or affiliates and is thus consistent with arm's-length principles of taxation. See Pet. App. B4 n.2 ("The 'water's-edge' method is essentially an [arm's length, separate accounting] method"). This case does not directly consider or address the "water's edge" method of taxation because it concerns tax years that preceded California's adoption of that method.

On September 10, 1993, California enacted legislation to remove the fee the State previously had imposed on corporations that elected "water's edge" treatment under the 1986 legislation and also to remove the preexisting regulatory authority under which respondent could disregard a "water's edge" election and require a corporation to report its

the California tax provisions in effect when this suit was commenced, the State generally ignored the separate corporate existence of parents, subsidiaries and affiliates engaged in a unitary business, pooled their world-wide income together, and allocated a portion of that combined income to California based upon a multi-factor apportionment formula.[4] See *Container Corp.* v. *Franchise Tax Board*, 463 U.S. 159, 162-163 (1983). Prior to the adoption of extensive revisions in the California tax scheme in 1986 and 1993 (see note 3, *supra*), California applied its worldwide combined reporting method not only to domestic parent corporations with foreign subsidiaries (see *ibid.*) but also to domestic subsidiaries (conducting business in California) with foreign parents and to foreign parents (conducting business in California) with foreign subsidiaries.

The United States has long taken the position that California's application of the worldwide combined reporting method of taxation to corporations doing business in Cali-

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income on a worldwide apportionment basis. See page 9, *infra*. Under this new legislation, both domestic and foreign corporations subject to tax in California may now freely elect taxation under the "water's edge" method. See *ibid.* The State has abandoned any mandatory requirement or economic compulsion designed to impose worldwide formulary apportionment on foreign corporate groups – and has thus abandoned the tax system that petitioners seek to challenge in this case.

[4] Under the three-factor apportionment formula used by California, the in-state corporation's income is calculated as a percentage of the total income of the group of related corporations. After the unitary business group is identified, the in-state corporation's sales, property, and payroll are expressed as a fraction of the total sales, property, and payroll of the unitary group. These three fractions are arithmetically averaged. This average is then multiplied against worldwide group income to yield the taxable income of the in-state corporation (Pet. App. C5).

fornia that have foreign parents or foreign affiliates is inconsistent with the "separate accounting" or "arm's length" method applied under federal law and under established international practice. In letters addressed in 1986 to the governors of the six States that then employed the worldwide combined reporting method of taxation (Alaska, California, Idaho, Montana, New Hampshire and North Dakota), the Secretary of State expressed the concern of the United States that state use of worldwide combined reporting was "at odds with the position of the United States and has become a source of conflict with foreign states" (Pet. App. H44). Major trading nations advised the United States during this period that the worldwide combined reporting method of taxation applied by these States constituted "a serious obstacle to the further development of our trade and investment relationships" (*ibid.*). The United Kingdom went beyond the formal expression of diplomatic protest and, in 1985, enacted legislation to provide retaliatory tax treatment for United States corporations that operate in the States that apply the worldwide combined reporting method.[5]

2. The taxpayers involved in this case are Barclays Bank International Limited (BBI) and Barclays Bank of California (Barcal). During 1977, Barcal (a United States corporation conducting banking activities in California) was a wholly owned subsidiary of BBI (a United Kingdom corporation conducting an international banking business).[6] Both BBI and Barcal did business in California and were therefore subject to tax in that State (Pet. 4-5; Pet. App. A36-A38).

[5] The United Kingdom legislation would deny tax credits on the taxes owed by such corporations for dividends they receive from their United Kingdom subsidiaries. See Finance Act 1985, Pt. II, ch. I, § 54, and Sch. 13, ¶ 5 (Eng.), reenacted without substantial change in Income and Corporation Taxes Act 1988, Pt. XVIII, ch. III, § 812 and Sch. 30, ¶¶ 20 and 21 (Eng.). See also Parliamentary Debates (Hansard) 1014-1018 (10 July 1985); Secretary of State Shultz's letter to Governor Deukmejian (Pet. App. H45).

In computing its California income tax for 1977, Barcal used the separate accounting method and reported only the income it earned from California sources. In computing its California income tax for 1977, BBI reported not only the income it earned from California sources but also included (i) the income BBI earned from operating bank agencies and branches in the United Kingdom and approximately 33 nations or territories outside of the United Kingdom and (ii) the income earned by 70 subsidiaries (including Barcal) of BBI operating in 34 nations or territories outside of the United Kingdom. BBI did not, however, include the income of BBI's parent (see note 6, *supra*) or of the parent's subsidiaries. Thus, neither Barcal nor BBI submitted its California tax return under the worldwide combined reporting method required by California (Pet. 5-6; Pet. App. A36-A40).

The California Franchise Tax Board determined that Barcal and BBI were members of a worldwide unitary business conducted by all members of the Barclays Group. That Group included (i) Barcal, a wholly owned subsidiary of BBI doing business only in California; (ii) BBI, a United Kingdom corporation doing general retail and commercial banking in the United Kingdom and 34 other nations or territories outside the United Kingdom, including California; (iii) the subsidiaries of BBI in which BBI had more than a 50% interest; (iv) Barclays Bank Limited, a United Kingdom corporation which conducted

[6] BBI was a wholly owned subsidiary of Barclays Bank Limited, a United Kingdom corporation. In 1982, Barclays Bank Limited changed its name to Barclays Bank PLC, which is named as the petitioner in this case (Pet. 2-3).

no business in California and which owned 100% of the stock of BBI; and (v) the subsidiaries of Barclays Bank Limited in which that corporation held more than a 50% interest. The California Franchise Tax Board calculated the tax owed by BBI and Barcal by allocating a portion of the total income of the above unitary group to these two taxpayers utilizing a three-factor apportionment formula. The State's calculation indicated a tax deficiency, which the Board then assessed (Pet. 8-9; Pet. App. A38-A41).

3. Barcal and BBI challenged the State's assessment because it was based not only on the income that they had separately earned but also on the income of their foreign parent and other related foreign subsidiaries which do no business in California or elsewhere in the United States. After paying the assessments, the taxpayers sued for a refund in California superior court (Pet. App. A38-A41).

The trial court entered judgment in favor of the taxpayers (Pet. App. A1-A34). The court concluded that California's computation of taxes by use of worldwide combined reporting improperly included income earned by foreign parents and affiliates of the taxpayers. The court held that this violated the Commerce Clause of the United States Constitution because it impeded the federal government's ability to speak with one voice in the conduct of foreign affairs (*id.* at A23-A26), impermissibly discriminated against foreign commerce (*id.* at A26-A28) and violated due process (*id.* at A29-A30).[7]

The California court of appeal affirmed (Pet. App. B1-B37). The appellate court held that California's appli-

[7] The trial court reasoned that the procedures then applicable for implementation of the State's worldwide combined reporting method violated due process because, "with customarily and currently available accounting data, literal compliance with [their] requirements is impossible for foreign multi-nationals" (Pet. App. A29).

cation of worldwide combined reporting to the income received by foreign parents and affiliates of the taxpayers violated the Commerce Clause because it frustrated the ability of the United States to speak with one voice with respect to an issue of foreign commercial relations where federal uniformity is necessary (*id.* at B35).

The California Supreme Court reversed, upholding the constitutionality of the tax under the Commerce Clause as applied in this case. The court relied extensively on the fact that, while Congress has been given many opportunities, it has not enacted legislation to prohibit the States from employing the worldwide combined reporting method to multinational corporations (Pet. App. C28-C31). Concluding from "the din" of this legislative "silence" that Congress "has decided *not* to prohibit state use" of worldwide combined reporting "in cases of this kind" (*id.* at C26), the court declined to apply the Commerce Clause to prohibit the State from enforcing a tax that Congress has not acted affirmatively to prohibit (*id.* at C24-C37).

Since the court of appeal had resolved the case without reaching petitioner's separate claims that the compliance burden imposed on foreign corporations (see note 7, *supra*) violated due process and effected a direct discrimination against foreign corporations, the California Supreme Court remanded the case to the court of appeal for further proceedings on those issues (Pet. App. C39). A petition for a writ of certiorari filed at that stage was denied by this Court. 113 S. Ct. 202 (1992).

4. On remand, the California court of appeal concluded that, while the costs of complying with the California tax were greater for foreign-based corporate groups than for domestic groups, the additional burdens were not unreasonable or arbitrary and did not violate due process (Pet. App. D14-D27). The court further held that the burdens imposed by the California compliance system did

not discriminate against foreign commerce (*id.* at D6-D14).

The California Supreme Court denied Barclays' petition for further review (Pet. App. E).[8]

DISCUSSION

For the reasons set forth in the brief filed by the United States as *amicus curiae* at an earlier stage of this case (*Am.* U.S. Br. No. 92-212), the analysis and holdings of the California Supreme Court are subject to serious question. Legislation adopted by California since the date of that submission, however, leads us to conclude that further review of the decision below is not warranted.

1. This case involves state corporate income taxes for 1977 that were assessed under a statutory scheme that no longer exists. As early as 1986, California responded to the urgings of the United States (see Pet. App. H3) and began the process of moving away from the worldwide combined reporting method for taxing the foreign incomes of foreign corporate groups. The State's adoption of the "water's edge election" in 1986—which gave corporations an opportunity to avoid an apportioned tax on the earnings of their foreign parents and affiliates—was a significant step in that direction. See note 3, *supra*. As the court of appeal noted in this case, California's " 'water's-edge' method is essentially an [arm's-length, separate-accounting] method" (Pet. App. B4 n.2) and thus generally conforms to federal and international tax practice.

[8] Petitioner seeks review of the additional rulings of the California court of appeal on remand as well as the original ruling of the California Supreme Court under the Commerce Clause. In this brief, we address only the Commerce Clause ruling entered by the California Supreme Court in its original decision in this case.

Even after the changes in California law in 1986, however, foreign governments continued to express concern that the annual fee then charged by California to corporations that elected "water's edge" treatment—as well as other, associated conditions on the election (see Pet. App. B4 n.2)—persisted as a meaningful, practical burden on the exercise of that option. Responding to these concerns, in legislation enacted on September 10, 1993, California extensively revised the State's corporate income tax system. See Cal. S.B. 671 (1993). Under this new legislation, the State (i) removed the annual fee previously imposed for "water's edge" treatment (*id.* §§ 24, 26), (ii) removed burdensome reporting requirements previously applicable to "water's edge" treatment (*id.* § 13) and (iii) removed any authority under which respondent could disregard a corporation's election and require it to file its return on a worldwide combined reporting basis (*id.* §§ 16, 23).[9]

Under the revised California legislation, the worldwide combined reporting method for assessing tax on foreign corporations is no longer compulsory in California. By invoking the provisions of the revised "water's edge" election, corporate taxpayers in California now have an unburdened right to be taxed on an "arm's length" basis and to exclude the earnings of their foreign parents or affiliates from the State's tax.[10] *Ibid.*

[9] This legislation was signed into law by the Governor of California on October 6, 1993.

[10] The "water's edge" election now offered by California does not appear to be illusory or to discriminate against foreign companies. The principal departure of the "water's edge" election from ordinary separate accounting methods is that, under the California provision, the earnings of affiliates and parents must be combined with the taxpayer's earnings when the average of the "property, payroll and sales factors" of the affiliate or parent within the United States "is 20 per-

2. Because California has abandoned compulsory worldwide combined reporting for foreign corporate groups, the issue presented and decided in the California Supreme Court in this case lacks substantial recurring importance. Corporate taxpayers in California are now generally free to elect to be taxed only on their separate earnings – and not on the earnings of their foreign parents or affiliates – under the "water's edge" method. By removing any mandatory requirement or economic compulsion for taxpayers to report their income under the worldwide combined reporting method, California's recent modifications of its tax system have brought that State's law into acceptable harmony with federal and international "arm's length" tax practice. See note 10, *supra*.

A decision by this Court on the constitutional question posed in this case is thus unnecessary to achieve adequate consistency in the Nation's regulation of foreign commerce, which California has striven to accomplish through its voluntary action. Further review by this Court is not needed to achieve, and could potentially destabilize, the accommodation of state, national and international interests that has been reached on this issue.

cent or more" (Cal. Rev. & Tax. Code § 25110(a)(3) (West 1992)). As we have noted, separate accounting tax systems often contain distinctions and refinements that depart from a strict application of the arm's-length concept. See note 1, *supra*. The record of this case, which concerns the State's tax system *before* the "water's edge" election was adopted, is obviously inadequate to address any issues that might hereafter arise in connection with enforcement of the State's new legislation.

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted.

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No. 92-1384

In The

Supreme Court of the United States

October Term, 1993

BARCLAYS BANK PLC,

Petitioner,

v.

FRANCHISE TAX BOARD,
An Agency of the State of California,

Respondent.

On Petition For A Writ Of Certiorari
To The Court Of Appeal Of The State Of California
In And For The Third Appellate District

SUPPLEMENTAL BRIEF OF RESPONDENT FRANCHISE TAX BOARD IN OPPOSITION TO PETITION FOR WRIT OF CERTIORARI

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Pursuant to Rule 15.7, respondent Franchise Tax Board files this supplemental brief to its brief in opposition to taxpayer's petition for writ of certiorari to inform this Court of legislation recently enacted by the State of California which modifies the elective water's-edge combined report method originally adopted by California in 1986 (Stats. 1986, chapter 660) and applicable to income years beginning on or after January 1, 1988. The earlier water's-edge legislation was discussed at page 6 of the

Franchise Tax Board's opposition brief and at footnote 1 (pp. 2-3) of petitioner's reply brief.

STATUTORY PROVISIONS

Appendix A to this supplemental brief in response contains excerpts from chapter 881 of the 1993 California statutes, which was signed into law by the Governor of the State of California on October 6, 1993.

ADDENDUM TO THE SUPPLEMENTAL STATEMENT OF THE CASE

On October 6, 1993, the Governor of the State of California signed into law Senate Bill 671 (Alquist), which became chapter 881 of this year's California laws. Sections 13, 16, and 22 through 26 of chapter 881 modify the operations of water's-edge combined report accounting method election originally added to California law in 1986, operative beginning January 1, 1988. Those sections of the 1993 chaptered bill are included in Appendix A to this brief. Section 34 provides that those modifications are operative beginning January 1, 1994.

California originally enacted the water's-edge combined report accounting election as a result of discussions held under the aegis of the Worldwide Unitary Taxation Working Group, which was formed at the request of President Ronald Reagan in 1983. The 1986 enactment of

the California legislation prompted senior Treasury officials to retreat from their previous insistence that Congress prohibit state use of worldwide formula apportionment. Petition Appendix C, pp. C-36 to C-37.

During the pendency of this petition the United Kingdom has threatened to implement (Letter of Ian Spence, Director International Division, Inland Revenue, Tax Notes Today, 93 TNT 124-23, June 11, 1993) retaliatory legislation against United States based companies if a "satisfactory resolution" were not found to the question of unitary taxation before the end of 1993.

The United Kingdom and the European Economic Community apparently had three major concerns with the California water's-edge combined report election as first enacted in 1986. First, they objected to the retained ability of the Franchise Tax Board to require taxpayers to use the worldwide combined report method under certain circumstances. Second, they objected to the conditioning of the right to elect upon the payment of a fee. And third, they objected to the reporting requirements imposed by the "Domestic Disclosure Spreadsheet."

The amendments to California law make three major changes in the operation of the water's-edge combined report accounting method. These changes are:

> 1. Removal of current section 25111(c) of the California Revenue and Taxation Code, which provided the California Franchise Tax Board with the authority to disregard a water's-edge election in three specified circumstances. See Section 23.

In place of the ability to disregard a water's-edge election, the legislation provides the Franchise Tax Board with additional authority to impose monetary penalties in aid of its audit efforts and provides it with broad authority to redetermine income if the requested information is not provided. Section 16. The provisions of this section are modeled after 26 U.S.C. section 6038A.

2. Amendment of California Revenue and Taxation Code section 25115, effective for income years beginning on or after January 1, 1984, to eliminate the requirement that any election fee be paid to make the water's-edge election. Section 26.

3. Replacement of the "Domestic Disclosure Spreadsheet" with an "information return" which identifies the corporate parent and those affiliates of which more than 20 percent of the voting stock is directly or indirectly controlled by the parent corporation. Section 13.

On September 14, 1993, subsequent to the legislative passage of this legislation, the Chancellor of the Exchequer of the United Kingdom, the Rt. Hon. Kenneth Clarke QC MP, addressed a letter to the United States Secretary of the Treasury, Hon. Lloyd Bentson. This letter contained the United Kingdom government's official reaction to the California Legislation. While noting that the United Kingdom still supports the taxpayer petitioner in the *Barclays* case, the letter officially acknowledges that, as a result of the California legislation, the United Kingdom will defer the implementation of any retaliatory measures. 1993 Tax Analysts State Tax Notes, 93 STN 181-16 (September 20, 1993).

CONCLUSION

For the reasons given in respondent Franchise Tax Board's brief in opposition to the petition, and in light of the additional facts presented above, it is respectfully submitted that the petition for writ of certiorari should be denied.

Dated: October 8, 1993.

Respectfully submitted,

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APPENDIX A

CALIFORNIA STATUTES

1993-94 REGULAR SESSION

CHAPTER 881

SENATE BILL NO. 671

The people of the State of California do enact as follows:

. . . .

SEC. 13. Section 18634 of the Revenue and Taxation Code, as added by Chapter 31 of the Statutes of 1993, is amended to read:

18634. (a) Any taxpayer determining its income subject to tax pursuant to Section 25101 or making the election under Section 25110 shall file with the Franchise Tax Board within six months after the due date (including extensions) of the bank's or corporation's California return required under this part an information return if it and its related banks' or corporations' total assets exceed two hundred million dollars ($ 200,000,000), or such higher levels as may be subsequently established by regulation.

(b) The information return shall be filed once every three years, unless there is a substantial change in the taxpayer's business activities, in which case it shall be filed for the year in which the change occurs.

(c) For purposes of this section, banks and corporations are related if more than 50 percent of the voting stock of one is directly or indirectly owned or controlled by the other or if more than 50 percent of the voting stock

of both is directly or indirectly owned or controlled by the same interest.

(d) The information return shall identify the corporate parent and those affiliates of which more than 20 percent of the voting stock is directly or indirectly owned or controlled by the parent. The information return shall identify the percentage of ownership and the type of corporation (foreign organized, United States organized, Foreign Sales Corporation, or other relevant descriptions).

(e) If the taxpayer willfully fails to substantially comply with this section, the taxpayer shall be subject to the penalty described in subdivision (d) of Section 19141.6.

(f) This section shall not apply to any bank or corporation with regard to any year if that bank's or corporation's payroll, property, and sales within the United States are each less than five hundred thousand dollars ($ 500,000).

. . . .

SEC. 16. Section 19141.6 is added to the Revenue and Taxation Code, to read:

19141.6. (a) Each taxpayer determining its income subject to tax pursuant to Section 25101 or electing to file pursuant to Section 25110 shall, for income years beginning on or after January 1, 1994, maintain (in the location, in the manner, and to the extent prescribed in regulations which shall be promulgated by the Franchise Tax Board on or before December 31, 1995) and make available upon request all of the following:

(1) Any records as may be appropriate to determine the correct treatment of the components that are a part of one or more unitary businesses for purposes of determining the income derived from or attributable to this state pursuant to Section 25101 or 25110.

(2) Any records as may be appropriate to determine the correct treatment of amounts that are attributable to the classification of an item as business or nonbusiness income for purposes of Article 2 (commencing with Section 25120) of Chapter 17 of Part 11.

(3) Any records as may be appropriate to determine the correct treatment of the apportionment factors for purposes of Article 2 (commencing with Section 25120) of Chapter 17 of Part 11.

(4) Documents and information, including any questionnaires completed and submitted to the Internal Revenue Service that are necessary to audit issues involving attribution of income to the United States or foreign jurisdictions under Section 882 and Subpart F of Part III of Subchapter N, or similar sections, of the Internal Revenue Code.

(b) For purposes of this section:

(1) Information for any year shall be retained for that period of time in which the taxpayers' income or franchise tax liability to this state may be subject to adjustment, including all periods in which additional income or franchise taxes may be assessed, not to exceed eight years from the due date or extended due date of the return, or during which a protest is pending before the Franchise Tax Board, or an appeal is pending before the

State Board of Equalization or a lawsuit is pending in the courts of this state or the United States with respect to California franchise or income tax.

(2) "Related party" means banks and corporations that are related because one owns or controls directly or indirectly more than 50 percent of the stock of the other or because more than 50 percent of the voting stock of each is owned or controlled, directly or indirectly, by the same interests.

(3) "Records" includes any books, papers, or other data.

(c)(1) If a bank or corporation subject to this section fails to maintain or fails to cause another to maintain records as required by subdivision (a), or willfully fails to comply substantially with Section 18634 requiring the filing of an information return, that bank or corporation shall pay a penalty of ten thousand dollars ($ 10,000) for each income year with respect to which the failure occurs.

(2) If any failure described in paragraph (1) continues for more than 90 days after the day on which the Franchise Tax Board mails notice of the failure to the bank or corporation, that bank or corporation shall pay a penalty (in addition to the amount required under paragraph (1)) of ten thousand dollars ($ 10,000) for each 30-day period (or fraction thereof) during which the failure continues after the expiration of the 90-day period. The additional penalty imposed by this subdivision shall not exceed a maximum of fifty thousand dollars ($ 50,000) if the failure to maintain or the failure to cause another to maintain is not willful. This maximum shall apply with respect to income years beginning on or after January 1, 1994, and before the earlier of the first day of the month following the month in which regulations are adopted pursuant to this section or December 31, 1995.

(3) For purposes of this section, the time prescribed by regulations to maintain records (and the beginning of the 90-day period after notice by the Franchise Tax Board) shall be treated as not earlier than the last day on which (as shown to the satisfaction of the Franchise Tax Board) reasonable cause existed for failure to maintain the records.

(d) (1) The Franchise Tax Board may apply the rules of paragraph (2) whether or not the board begins a proceeding to enforce a subpoena, or subpoena duces tecum, if subparagraph (A), (B), and (C) apply:

(A) For purposes of determining the correct treatment under Part 11 (commencing with Section 23001) of the items described in subdivision (a), the Franchise Tax Board issues a subpoena or subpoena duces tecum to a bank or corporation to produce (either directly or as agent for the related party) any records or testimony.

(B) The subpoena or subpoena duces tecum is not quashed in a proceeding begun under paragraph (3) and is not determined to be invalid in a proceeding begun under Section 19504 to enforce the subpoena.

(C) The bank or corporation does not substantially comply in a timely manner with the subpoena or subpoena duces tecum and the Franchise Tax Board has sent by certified or registered mail a notice to that bank or corporation that it has not substantially complied.

(D) If the bank or corporation fails to maintain or fails to cause another to maintain records as required by subdivision (a), and by reason of that failure, the subpoena, or subpoena duces tecum, is quashed in a proceeding described in subparagraph (B) or the bank or corporation is not able to provide the records requested in the subpoena or subpoena duces tecum, the Franchise Tax Board may apply the rules of paragraph (2) to any of the items described in subdivision (a) to which the records relate.

(2) (A) All of the following shall be determined by the Franchise Tax Board in the Franchise Tax Board's sole discretion from the Franchise Tax Board's own knowledge or from the information as the Franchise Tax Board may obtain through testimony or otherwise:

(i) The components that are a part of one or more unitary businesses for purposes of determining the income derived from or attributable to this state pursuant to Section 25101 or 25110.

(ii) Amounts that are attributable to the classification of an item as business or nonbusiness income for purposes of Article 2 (commencing with Section 25120) of Chapter 17 of Part 11.

(iii) The apportionment factors for purposes of Article 2 (commencing with Section 25120) of Chapter 17 of Part 11.

(iv) The correct amount of income under Section 882 of Subpart F of the Internal Revenue Code, or similar sections of the Internal Revenue Code.

(B) This paragraph shall apply to determine the correct treatment of the items described in subdivision (a) unless the bank or corporation is authorized by its related parties (in the manner and at the time as the Franchise Tax Board shall prescribe) to act as the related parties' limited agent solely for purposes of applying Section 19504 with respect to any request by the Franchise Tax Board to examine records or produce testimony related to any item described in subdivision (a) or with respect to any subpoena or subpoena duces tecum for the records or testimony. The appearance of persons or the production of records by reason of the bank or corporation being an agent shall not subject those persons or records to legal process for any purpose other than determining the correct treatment under Part 11 of the items described in subdivision (a).

(3) (A) Notwithstanding any other law or rule of law, any reporting bank or corporation to which the Franchise Tax Board issues a subpoena or subpoena duces tecum referred to in subparagraph (A) of paragraph (1) shall have the right to begin a proceeding to quash the subpoena not later than the 90th day after the subpoena was issued. In that proceeding, the Franchise Tax Board may seek to compel compliance with the subpoena.

(B) Notwithstanding any other law or rule of law, any reporting bank or corporation that has been notified by the Franchise Tax Board that it has determined that the bank or corporation has not substantially complied with a subpoena or subpoena duces tecum referred to in paragraph (1) shall have the right to begin a proceeding to review the determination not later than the 90th day after

the day on which the notice referred to in subparagraph (C) of paragraph (1) was mailed. If the proceeding is not begun on or before the 90th day, the determination by the Franchise Tax Board shall be binding and shall not be reviewed by any court.

(C) The superior courts of the State of California for the Counties of Los Angeles, Sacramento, and San Diego, and for the City and County of San Francisco shall have jurisdiction to hear any proceeding brought under subparagraphs (A) and (B). Any order or other determination in the proceeding shall be treated as a final order that may be appealed.

(D) If any bank or corporation takes any action as provided in subparagraphs (A) and (B), the running of any period of limitations under Sections 19057 to 19064, inclusive (relating to the assessment and collection of tax), or under Section 19704 (relating to criminal prosecutions) with respect to that bank or corporation shall be suspended for the period during which the proceedings, and appeals therein, are pending. In no event shall any period expire before the 90th day after the day on which there is a final determination in the proceeding.

. . . .

SEC. 22. Section 25110 of the Revenue and Taxation Code, as amended by Chapter 31 of the Statutes of 1993, is amended to read:

25110. (a) Notwithstanding Section 25101, a qualified taxpayer, as defined in paragraph (2) of subdivision (b) which is subject to the tax imposed under this part, may elect, subject to the provisions of Section 25111, to

account for and determine its income derived from or attributable to sources within this state pursuant to a water's-edge election in accordance with the provisions of this part, as modified by this article. A taxpayer which makes that water's-edge election shall take into account the income and apportionment factors of the following affiliated entities only:

(1) Affiliated banks or corporations which are eligible to be included in a federal consolidated return as described in Sections 1501 to 1505, inclusive, of the Internal Revenue Code, other than corporations making an election under Section 936 of the Internal Revenue Code.

(2) Domestic international sales corporations, as described in Sections 991 to 994, inclusive, of the Internal Revenue Code and foreign sales corporations as described in Sections 921 to 927, inclusive, of the Internal Revenue Code.

(3) Any corporation, regardless of the place where it is incorporated if the average of its property, payroll, and sales factors within the United States is 20 percent or more.

(4) Banks and corporations which are incorporated in the United States, excluding corporations making an election pursuant to Sections 931 to 936, inclusive, of the Internal Revenue Code, of which more than 50 percent of their stock is controlled directly or indirectly by the same interests, which are not included in paragraph (1).

(5) A bank or corporation which is not described in paragraphs (1) to (4), inclusive, or paragraph (6), but only to the extent of its income derived from or attributable to

sources within the United States and its factors assignable to a location within the United States in accordance with paragraph (3) of subdivision (b). Income of such a bank or corporation derived from or attributable to sources within the United States as determined by federal income tax laws shall be limited to and determined from the books of account maintained by the bank or corporation with respect to its activities conducted within the United States.

(6) Export trade corporations, as described in Sections 970 to 972, inclusive, of the Internal Revenue Code.

(7) Any affiliated bank or corporation which is a "controlled foreign corporation," as defined in Section 957 of the Internal Revenue Code, if all or part of the income of that affiliate is defined in Section 952 of Subpart F of the Internal Revenue Code ("Subpart F income"). The income and apportionment factors of any affiliate to be included under this paragraph shall be determined by multiplying the income and apportionment factors of that affiliate without application of this paragraph by a fraction (not to exceed one), the numerator of which is the "Subpart F income" of that bank or corporation for that income year and the denominator of which is the "earnings and profits" of that bank or corporation for that income year, as defined in Section 964 of the Internal Revenue Code.

(8) (A) The income and factors of the above-enumerated banks and corporations shall be taken into account only if the income and factors would have been taken into account under Section 25101 if this section had not been enacted.

(B) The income and factors of a bank or corporation which is not described in paragraphs (1) to (4), inclusive, and (6) and which is an electing taxpayer under this subdivision shall be taken into account in determining its income only to the extent set forth in paragraph (5).

(b) For purposes of this article and Section 24411:

(1) An "affiliated bank or corporation" means a bank or corporation which is related to a bank or corporation, required to file under this part, because of any of the following:

(A) It owns directly or indirectly more than 50 percent of the voting stock of the bank or corporation required to file under this part.

(B) More than 50 percent of its voting stock is owned directly or indirectly by a bank or corporation required to file under this part.

(C) More than 50 percent of voting stock of both it and the bank or corporation required to file under this part is owned or controlled directly or indirectly by any bank or person (as defined in Section 7701(a)(1) of the Internal Revenue Code).

(2) A "qualified taxpayer" means a bank or corporation which does both of the following:

(A) Files with the state tax return on which the water's-edge election is made a consent to the taking of depositions at the time and place most reasonably convenient to all parties from key domestic corporate individuals and to the acceptance of subpoenas duces tecum requiring reasonable production of documents to the Franchise Tax Board as provided in Section 19504 or by

the State Board of Equalization as provided in Title 18, California Code of Regulations, Section 5005, or by the courts of this state as provided in Chapter 2 (commencing with Section 1985) of Title 3 of Part 4 of, and Section 2025 of, the Code of Civil Procedure. The consent relates to issues of jurisdiction and service and does not waive any defenses a taxpayer may otherwise have. The consent shall remain in effect so long as the water's-edge election is in effect and shall be limited to providing that information necessary to review or to adjust income or deductions in a manner authorized under Sections 482, 861, Subpart F of Part III of Subchapter N, or similar provisions of the Internal Revenue Code, together with the regulations adopted pursuant to those provisions, and for the conduct of an investigation with respect to any unitary business in which the taxpayer may be involved.

(B) Agrees that for purposes of this article, dividends received by any bank or corporation whose income and apportionment factors are taken into account pursuant to subdivision (a) from either of the following are functionally related dividends and shall be presumed to be business income:

(i) A bank or corporation of which more than 50 percent of the voting stock is owned, directly or indirectly, by members of the unitary group and which is engaged in the same general line of business.

(ii) Any bank or corporation which is either a significant source of supply for the unitary business or a significant purchaser of the output of the unitary business, or which sells a significant part of its output or obtains a significant part of its raw materials or input

from the unitary business. "Significant," as used in this subparagraph, means an amount of 15 percent or more of either input or output.

All other dividends shall be classified as business or nonbusiness income without regard to this subparagraph.

(3) The definitions and locations of property, payroll, and sales shall be determined under the laws and regulations which set forth the apportionment formulas used by the individual states to assign net income subject to taxes on or measured by net income in that state. If a state does not impose a tax on or measured by net income or does not have laws or regulations with respect to the assignment of property, payroll, and sales, the laws and regulations provided in Article 2 (commencing with Section 25120) shall apply.

Sales shall be considered to be made to a state only if the bank or corporation making the sale may otherwise be subject to a tax on or measured by net income under the Constitution or laws of the United States, and shall not include sales made to a bank or corporation whose income and apportionment factors are taken into account pursuant to subdivision (a) in determining the amount of income of the taxpayer derived from or attributable to sources within this state.

(4) "The United States" means the 50 states of the United States and the District of Columbia.

(c) All references in this part to income determined pursuant to Section 25101 shall also mean income determined pursuant to this section.

SEC. 23. Section 25111 of the Revenue and Taxation Code, as amended by Chapter 31 of the Statutes of 1993, is amended to read:

25111. (a) The making of a water's-edge election as provided for in Section 25110 shall be made by contract with the Franchise Tax Board in the original return for a year and shall be effective only if every taxpayer which is a member of the water's-edge group and which is subject to tax under this part makes the election. A single taxpayer which is engaged in more than one business activity subject to allocation and apportionment as provided in Article 2 (commencing with Section 25120) of Chapter 17 may make a separate election for each business. The form and manner of making the water's-edge election shall be prescribed by the Franchise Tax Board. Each contract making a water's-edge election shall be for an initial term of 84 months, except as provided in subdivisions (b). Each contract shall provide that on the anniversary date of the contract or any other annual date specified by the contract a year shall be added automatically to the initial term unless notice of nonrenewal is given as provided in subdivision (d). An affiliated bank or corporation which is a member of the water's-edge group and subsequently becomes subject to tax under this part or is a nonelecting taxpayer which is subsequently proved to be a member of the water's-edge group pursuant to Franchise Tax Board audit determination, as evidenced by a notice of deficiency proposed to be assessed or a notice of tax change, shall be deemed to have elected.

No water's-edge election shall be made for an income year beginning prior to January 1, 1988.

(b) A water's-edge election may be terminated by a taxpayer prior to the end of the 84-month period if either of the following occurs:

(1) The taxpayer is acquired directly or indirectly by a nonelecting entity which alone or together with those affiliates included in its combined report is larger than the taxpayer as measured by equity capital.

(2) With the permission of the Franchise Tax Board.

(c) In granting a change of election, the Franchise Tax Board shall impose any conditions which are necessary to prevent the avoidance of tax or clearly reflect income for the period the election was, or was purported to be, in effect. These conditions may include a requirement that income, including dividends paid from income earned while a water's-edge election was in effect, which would have been included in determining the income of the taxpayer from sources within and without this state pursuant to Section 25101 but for the water's-edge election shall be included in income in the year in which the election is changed.

(d) If the taxpayer desires in any year not to renew the election, the taxpayer shall serve written notice of nonrenewal upon the board at least 90 days in advance of the annual renewal date. Unless that written notice is provided to the board, the election shall be considered renewed as provided in subdivision (a).

(e) If the taxpayer serves notice of intent in any year not to renew the existing water's-edge election, that existing election shall remain in effect for the balance of the

period remaining since the original election or the last renewal of the election, as the case may be.

SEC. 24. Section 25111.1 is added to the Revenue and Taxation Code, to read:

25111.1. For any income year beginning on or after January 1, 1994, consideration for water's-edge contracts in existence as of that date is no longer provided for by law. Those contracts are rescinded for any periods remaining on the contracts commencing on the first day of the taxpayer's income year that begins on or after January 1, 1994. Any fiscal year taxpayer whose contract is in effect as of December 31, 1993, shall continue to be bound by that contract until the close of its income year after January 1, 1994, and before December 31, 1994.

SEC. 25. Section 25112 of the Revenue and Taxation Code, as amended by Chapter 31 of the Statutes of 1993, is amended to read:

25112. (a) If a taxpayer electing to file under Section 25110 fails to supply any information described in subdivision (b), the taxpayer shall pay a penalty of one thousand dollars ($ 1,000) for each income year with respect to which the failure occurs.

(b) A taxpayer electing pursuant to Section 25110 shall do all of the following:

(1) Retain and make available upon request the documents and information, including any questionnaires completed and submitted to the Internal Revenue Service or qualified states, which are necessary to audit issues involving attribution of income to the United States or foreign jurisdictions under Sections 482, 861, 863, 902, and 904, and Subpart F of Part III of Subchapter N, or similar sections of the Internal Revenue Code.

(2) Identify, upon request, principal officers or employees who have substantial knowledge of, and access to, documents and records which discuss pricing policies, profit centers, cost centers, and the methods of allocating income and expense among these centers. The information shall include the employees' titles and addresses.

(3) Retain and make available upon request all documents and correspondence ordinarily available to a bank or corporation included in the water's-edge election which are submitted to, or obtained from, the Internal Revenue Service, foreign countries or their territories or possessions, and competent authority pertaining to ruling requests, rulings, settlement resolutions, and competing claims involving jurisdictional assignment and sourcing of income that affect the assignment of income to the United States. The documents shall include all ruling requests and rulings on reorganizations involving foreign incorporation of branches, all ruling requests and rulings on changing a bank or corporation's jurisdictional incorporation, and all documents which are ordinarily available to a bank or corporation included in the water's-edge election which pertain to the determination of foreign tax liability, including examination reports issued by foreign taxing administrations. If the documents have been translated, the translations shall be furnished.

(4) Upon request, prepare and make available for each bank or corporation included in the information return referred to in Section 18634 in which the taxpayer

is included, a list of each state of the United States, including the District of Columbia, territories or possessions, and each foreign country in which it has payroll, property, or sales. The sales shall be determined by destination whether or not the taxpayer is taxable in the destination jurisdiction.

(5) Retain and make available, upon request, information filed with the Internal Revenue Service to comply with Sections 6038, 6038A, 6038B, 6038C, and 6041 of the Internal Revenue Code.

(6) Upon request, prepare and make available for each bank or corporation organized or created under the laws of the United States or a political subdivision thereof, of which 50 percent or more of its voting stock is directly or indirectly owned or controlled, the information which would be included in the forms described in paragraph (5) if those forms were required for United States corporations.

(7) Retain and make available, upon request, all state tax returns filed by each bank or corporation included under subdivision (a) in each state, including the District of Columbia.

(8) Comply with reasonable requests for information necessary to determine or verify its net income, apportionment factors, or the geographic source of that income pursuant to the Internal Revenue Code.

(9) For purposes of this subdivision, information for any year shall be retained for that period of time in which the taxpayer's income or franchise tax liability to this state may be subject to adjustment, including all periods

in which additional income or franchise taxes may be assessed or during which an appeal is pending before the State Board of Equalization or a lawsuit is pending in the courts of this state or the United States with respect to California franchise or income tax.

(c) If the failure continues for more than 90 days after the date on which the Franchise Tax Board mails notice of that failure to the taxpayer, the taxpayer shall pay a penalty (in addition to the amount required under subdivision (a)) of one thousand dollars ($ 1,000) for each 30-day period (or fraction thereof) during which the failure continues after the expiration of the 90-day period. The increase in any penalty under this subdivision shall not exceed twenty-four thousand dollars ($ 24,000).

(d) If the taxpayer fails to comply substantially with any formal document request arising out of the examination of the tax treatment of any item (hereinafter in this section referred to as the "examined item") before the 90th day after the date of the mailing of the request, any court having jurisdiction of a civil proceeding in which the tax treatment of the examined item is an issue may, upon motion by the Franchise Tax Board, prohibit the introduction by the taxpayer of documentation covered by that request.

(e) For purposes of this section, the time in which information is to be furnished (and the beginning of the 90-day period after notice by the Franchise Tax Board) shall be treated as beginning not earlier than the last day on which reasonable cause existed for failure to furnish the information.

(f) This section shall not apply with respect to any requested documentation if the taxpayer establishes that the failure to provide the documentation, as requested by the Franchise Tax Board, is due to reasonable cause. For purposes of subdivision (d), the fact that a foreign jurisdiction would impose a civil or criminal penalty on the taxpayer (or any other person) for disclosing the requested documentation is not reasonable cause unless, after in-camera review of the documentation, the court finds otherwise.

(g) For purposes of this section, the term "formal document request" means any request (made after the normal request procedures have failed to produce the requested documentation) for the production of documentation which is mailed by registered or certified mail to the taxpayer at its last known address and which sets forth all of the following:

(1) The time and place for the production of the documentation.

(2) A statement of the reason the documentation previously produced (if any) is not sufficient.

(3) A description of the documentation being sought.

(4) The consequences to the taxpayer of the failure to produce the documentation described in this section.

(h) Notwithstanding any other law or rule of law, any taxpayer to whom a formal document request is mailed may begin a proceeding to quash that request not later than the 90th day after the date the request was mailed. In any such proceeding, the Franchise Tax Board may seek to compel compliance with the request.

(i) The superior courts of the State of California for the Counties of Los Angeles, Sacramento, and San Diego, and for the City and County of San Francisco shall have jurisdiction to hear any proceeding brought under subdivision (h). An order denying the petition shall be deemed a final order which may be appealed.

The running of the 90-day period referred to in subdivision (c) shall be suspended during any period during which a proceeding brought under subdivision (h) is pending.

(j) For purposes of this section, "documentation" means any documentation which may be relevant or material to the tax treatment of the examined item.

(k) The Franchise Tax Board, and any court having jurisdiction over a proceeding under subdivision (g), may extend the 90-day period referred to in subdivision (b).

(l) If any bank or corporation takes any action as provided ~~in~~ subdivision (h), the running of any period of limitations under Sections 19057 to 19067, inclusive (relating to the assessment and collection of tax), or under Section 19704 (relating to criminal prosecutions) with respect to that bank or corporation shall be suspended for the period during which the proceedings under subdivision (h) and appeals thereto are pending.

SEC. 26. Section 25115 of the Revenue and Taxation Code is amended to read:

25115. (a) For income years beginning before January 1, 1994, each contract described in Section 25111 shall

provide that a taxpayer making a water's-edge election pursuant to this article shall pay an annual amount to the Franchise Tax Board for deposit in the California Unitary Fund created pursuant to Section 16429.30 of the Government Code. One-third of the amount shall be deposited in the Local Project Account for Non-Transient Spending in the California Unitary Fund, and two-thirds of the amount shall be deposited in the Future Infrastructure State Targeted Account in the California Unitary Fund.

(b) The amount shall be equal to thirty-thousandths of 1 percent of the sum of the taxpayer's property and payroll assigned to this state for an income year of 12 full months ending during the calendar year 1986 and its sales assigned to this state for the current income year. A single corporation which is engaged in more than one business for which it is making separate elections shall determine the amount as provided in this section for each business for which it is electing to determine its income pursuant to Section 25110.

(c) The sum of the property, payroll, and sales, as calculated pursuant to subdivision (b) shall be reduced by the cumulative amount expended since January 1, 1987, for investment in new plants or facilities in this state, as defined in subdivision (d), and shall further be reduced by the amount expended for new employees in this state as defined in subdivision (f).

(d) A new plant or facility is property described in Section 70, constructed by or for the taxpayer, or new tangible personal property, the original use of which commences with the taxpayer in this state, provided that it is not a replacement, in whole or in part, for an existing

plant or facility in this state. For purposes of this subdivision, "new tangible personal property" means the current year's acquisition of personal property classified as "machinery and equipment for industry, profession, or trade," "tools, molds, dies, jigs," and "computers and related equipment," as reported to either the county assessor pursuant to Section 441 or the State Board of Equalization pursuant to Section 826. A plant or facility shall be deemed a replacement if the taxpayer, or an affiliated bank or corporation, as defined in paragraph (1) of subdivision (b) of Section 25110, closes, takes out of service, sells, or leases to an unrelated party, in either the three immediately preceding or the three immediately succeeding years from the time the new plant or facility is operational, a plant or facility with a cost basis equal to 25 percent or more of the cost basis of the new plant or facility.

(e) The number of new employees in this state for any income year shall be determined by comparing the total number of work years in this state for the income year to the greater of (1) the average of the total number of work years in this state for the income years ending in 1985, 1986, and 1987, or (2) the total number of work years in this state for the income year ending in 1987. A "work year" means, in the case of workers who are paid an hourly wage, 2,000 paid hours, and in the case of salaried employees, a total of 12 paid months.

(f) The amount expended for new employees shall be equal to the product of the number of new employees determined pursuant to subdivision (e) and the average wages paid for each work year in this state for the income year.

(g) Each contract shall provide that the amount described in this section shall not be subject to any statutory changes, for the period the contract is in effect, without the consent of the taxpayer. Any statutory change shall be applicable for any renewal year beginning five years after that statutory change.

(h) Amounts determined pursuant to this section shall be collected and refunded in the same manner as the taxes imposed by this part and shall be subject to interest and penalties as provided in this part.

(i) In no event shall the amount determined pursuant to this section be less than ten-thousandths of 1 percent of the sum of the taxpayer's property, payroll, and sales in this state for the current year.

(j) For purposes of this section, the bank's or corporation's property, payroll, and sales in this state shall be determined pursuant to Article 2 (commencing with Section 25120) of Chapter 17, and regulations adopted pursuant thereto, except that both of the following shall apply:

(1) Property shall include only property defined in Sections 25129 to 25131, inclusive.

(2) Sales shall not include gross receipts from the sale of real property and improvements thereto and the sale of the stock of a subsidiary unless that activity occurs as a regular part of the taxpayer's business.

(k) The annual amount otherwise determined pursuant to this section and payable under a contract described in Section 25111 shall not be imposed for an

income year in which a taxpayer incurs no tax liability under Sections 25101 and 25110.

(l) If a taxpayer is reorganized into two or more separate entities, the 1986 property and payroll factors for the new entities shall be determined by the ratio of current property and payroll factors, excluding intangible property, for each new entity subject to tax in California to the total for all entities subject to tax in California for the year in which those entities are created. This ratio shall be applied to 1986 property and payroll and each entity shall be allocated a portion of the 1986 payments and payroll based on this ratio.

(m) Notwithstanding Section 24345, the amount imposed by this section shall be allowed as a deduction in computing the taxes imposed by this part.

(n) This section shall remain in effect until January 1, 1994, and as of that date is repealed.

. . . .

SEC. 34. This act provides for a tax levy within the meaning of Article IV of the Constitution and shall go into immediate effect. However, except as provided in Section 27, the provisions of this act shall become operative on January 1, 1994, and shall be applied in the computation of taxes for income years beginning on or after January 1, 1994.

No. 92-1384

In the Supreme Court

OF THE

United States

OCTOBER TERM, 1993

BARCLAYS BANK PLC
Petitioner,

vs.

FRANCHISE TAX BOARD,
AN AGENCY OF THE STATE OF CALIFORNIA
Respondent.

On Petition for a Writ of Certiorari to the Court of Appeal of the State of California in and for the Third Appellate District

SUPPLEMENTAL BRIEF OF PETITIONER

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SUPPLEMENTAL BRIEF OF PETITIONER

This case continues squarely to present the issue of the constitutionality of worldwide combined reporting (the "unitary tax") applied to a foreign corporation or a domestic corporation with a foreign parent or foreign affiliate, an issue twice reserved by this Court in *Container Corp. of America v. Franchise Tax Board*, 463 U.S. 159, 189 n.26, 195 n.32 (1983). Through the nine years of this litigation and through two prior Administrations, the United States has steadfastly taken the position that such application of the unitary tax is clearly unconstitutional. Now, as part of an election year accommodation by the new Administration, the United States—while effectively admitting the unconstitutionality of the California system at issue—nonetheless points to newly enacted California legislation as ostensibly providing a complete solution. Thus, says the United States, this case no longer presents an issue of "recurring importance." This position misses the mark for the following fundamental reasons:

1. The United States' major trading partners have made it clear that they do not consider the California legislation a sufficient solution to the unitary tax problem. The nature of this problem is such that requiring another case to wend its way through the courts, for the number of years which these complex cases take, risks the very retaliation that the foreign Commerce Clause seeks to avoid.

2. The issue presented here is of great importance to the international community and to the affected taxpayers because it involves $1 billion in taxes and fees already collected or to be collected under the admittedly unconstitutional California tax scheme. It is unfair—and disruptive of foreign relations—to allow the State of California to retain monies collected in violation of the Constitution. Moreover, by the very nature of the audit process, past tax years will continue to be the subject of future audits and assessments well into the next century, with the same potential for continuing foreign offense that has already caused the United States to conclude that the application of the system is unconstitutional.

3. The issue is of further recurring importance because at least six other states apply worldwide combined reporting in whole or in part. With the open invitation that the California Supreme Court opinion constitutes, it is highly likely that addi-

tional states will adopt this unconstitutional tax method, absent intervention by this Court.

4. Finally, by its very nature and for all of the above reasons, this issue requires a national solution now rather than a piecemeal state response. The United States itself has previously acknowledged to this Court that a uniform national solution is required. The new California legislation does not provide that.

STATEMENT

This case does not arise under a tax system "that no longer exists." Am. U.S. Br. No. 92-1384 at 8. California has not abandoned worldwide combined reporting which is and will remain its basic tax system. Six other states use worldwide combined reporting in whole or in part. Idaho, Montana and North Dakota use this as their basic system and Alaska (oil and oil pipeline companies) and Tennessee (financial institutions) mandate its use for special industries.[1]

This case is designated by Respondent as the determinant case on the constitutionality of worldwide combined reporting under the "one voice" test. Pet. App. I.[2] This case involves $500 million of refunds of taxes already collected under worldwide combined reporting and $350 million to $400 million of taxes to be collected. Pet. Supp. App. L p. A22. Refunds of fees paid for the "privilege" of electing out of worldwide combined reporting also rest on a determination of the system's constitutionality. Pet. Supp. App. M.

Even if all eligible taxpayers elect the new alternative in 1995,[3] California will continue to assess taxes under worldwide combined reporting under the usual audit cycles well into the next century.

[1]Utah permits elective worldwide combined reporting with a mandatory water's edge system.

[2] All references to the appendices in this supplemental brief are denominated "Pet. Supp. App." followed by the letter of each item. All references to the appendices in the Petition for Certiorari are denominated "Pet. App." Petitioner's Rule 29.1 statement is included in the Petition for Certiorari at 2-3 and Pet. App. G.

[3] The alternative is first applicable to years beginning on or after January 1, 1994. A taxpayer elects on the filing of its tax return for the first year of election. Cal. Rev. & Tax. Code § 25111.

Neither the United States nor foreign nations found California's 1986 water's edge legislation, first effective in 1988, sufficient to resolve controversy over worldwide combined reporting. Both before and after the enactment foreign governments and the United States continued to express concern over use by California and other states of worldwide combined reporting.

On September 10, 1993, the California Legislature amended California's earlier enacted alternative to its basic worldwide combined reporting taxation system (Senate Bill 671, Supp. Br. Resp. App. A) for two reasons: 1) to avoid the immediate threat of British retaliation; and 2) to make it possible for the Clinton Administration to file a "neutral" brief with the Supreme Court with respect to whether the Court should grant certiorari in this very case:

> The prior Administration had filed a brief with the Supreme Court on behalf of Barclays. But as a presidential candidate, Clinton assured California officials that he would side with the states on the issue.
>
> The threat of retaliation, however, naturally caused a seriously awkward situation for the new Administration, and Treasury representatives have requested that California's law be modified to remove the threat. California officials have been assured that if our law is changed in a manner which will remove the threat, then a neutral brief (to the effect that the Administration does not advise the Court to take up the *Barclays* case) would be filed.

Cal. Legislative Comm. Report on Senate Bill 671 (Pet. Supp. App. L p. A26).

In Senate Bill 671 the California Legislature also provided for tax *relief* for *California* businesses at a net cost to the state of over $2.3 billion dollars during the next seven years. Pet. Supp. App. L p. A22.

A number of recent events not mentioned by the United States in its brief are important to this Court's decision whether to grant review.

a. On May 13, 1993, the Chancellor of the Exchequer of the United Kingdom, in response to a Parliamentary Question, stated that he had informed United States Secretary of Treasury Bentsen: "[T]hat the Government will have to take retaliatory measures in relation to United States based companies if there is not a satisfactory resolution of the problem of the internationally-opposed unitary tax on foreign-owned companies in California by the end of this year." Pet. Supp. App. N p. A35.

b. In June, 1993, the Finance Committee of the German Bundestag issued a Resolution requesting the German Government to take immediate steps to consider the application of retaliatory measures should it prove impossible to achieve a satisfactory solution to the problem of unitary taxation within a reasonable time. Pet. Supp. App. O pp. A36-A37.

c. On September 15, 1993, the Chancellor of the Exchequer of the United Kingdom announced that, even after passage of Senate Bill 671, defects remained in California's law. The United Kingdom would defer retaliatory action and would retaliate "only if it is found that the [newly enacted California] legislation is being applied in a way which exposes UK owned companies to damage from taxation that is inconsistent with the arm's length principle." However, the Chancellor went on to state:

> While the legislation in California is a significant step forward, on its own it does not provide a complete solution to the unitary tax problem. For a complete solution it will be necessary to have the internationally accepted arm's length principle endorsed, on a permanent basis, as the only valid method of taxing foreign companies in any State. Success for the Barclays case in the Supreme Court would achieve this. The Government will continue strongly to support Barclays' case. I hope it will succeed. If it does not, the UK will have to retain its retaliatory powers in reserve as a barrier against the possibility that States might damage UK owned companies by the imposition of unitary taxation at some time in the future.

Pet. Supp. App. P p. A38.

d. On September 23, 1993, the Member States of the European Community and the Commission of the European Communities sent a diplomatic note to the State Department:

> While this legislation is an improvement, the Member States and the European Commission do not consider that the unitary tax problem is solved. Worldwide unitary taxation, which is contrary to the internationally agreed arm's length principle, is still the basis of the tax system in California. A complete solution will require the arm's length principle to be established as the only legitimate basis of taxing foreign companies in any state.

Pet. Supp. App. Q p. A40.

ARGUMENT

I.

This Case Presents A Substantial And Recurring Question Of Great Constitutional Importance And International Concern.

The United States concedes that the application of worldwide combined reporting to divide the international income of foreign owned groups violates the Commerce Clause. Thus the substantial amount of taxes already collected and yet to be collected under this unconstitutional scheme and substantial fees collected and to be collected from taxpayers for the "privilege" of avoiding the unconstitutional taxing scheme — probably totalling one billion dollars — are a continuing and recurring constitutional violation of great significance. This case is not moot.

The issue presented by this case has been of major and mounting concern for over 20 years. Twenty nations have filed amici curiae briefs in support of this petition for certiorari, in search of a national — not a California — resolution. These nations have consistently protested any state's use of this system which conflicts with the international standard of arm's length separate accounting. Twice the United Kingdom has taken more formal retaliatory steps (the second in the last few months, *see* Pet. Supp. App. N). The Finance Committee of the German Bundestag has also urged consideration of retaliation.[4] Pet. App. Supp. O p. A37. Nations perceive this case as providing such a

[4]This request has not been rescinded.

national solution. Pet. Supp. App. P p. A38, App. Q p. A40. They do not so perceive the California legislation. *Id.*

California makes no provision for return of amounts seen by both foreign governments and the United States as improperly collected. The legislation modifying its tax system has an avowed purpose of avoiding a decision in this case in order to keep taxes collected. Pet. Supp. App. L pp. A25-A27.[5] Such actions violate a fundamental sense of fairness. In areas which affect foreign relations, such incidents lead to harm to the Nation: "Experience has shown that international controversies of the gravest moment, sometimes even leading to war, may arise from real or imagined wrongs to another's subjects inflicted, or permitted, by a government." *Hines v. Davidowitz*, 312 U.S. 52, 64 (1941); *Chy Lung v. Freeman*, 92 U.S. 275, 279-80 (1875). Resolution now, particularly where this case concerns not imagined wrongs but constitutionally matured rights (*see Dennis v. Higgins*, 498 U.S. 439, 448 (1990)) is clearly necessary to avoid any further harm to this Nation's international relations.

Because the new legislation applies only to years beginning in 1994, the State will continue to impose its compulsory worldwide combined reporting system on all taxpayers that have income years open for assessment. Normal audit and assessment cycles extend that process well into the next century. This ongoing application of mandatory worldwide combined reporting to foreign unitary groups will continue foreign offense and the implication of United States foreign policy long after the new California legislation becomes effective.

The United States begrudgingly admits that California's prospective water's edge alternative does not conform to the international standard.[6] The constitutionality of combination of a foreign

[5]Lest there be concern over the effect on the State of an obligation to return or forebear collection of the sums at issue, the newly enacted California law provides for $2.3 billion of tax relief for California business over the next seven years. Pet. Supp. App. L p. A22.

[6]For example, once a foreign corporation crosses the California 20 percent threshold (20 percent of the average of its property, payroll and sales in the United States) 100 percent of its income is in the water's edge. Under the international standard, only that income from the permanent establishment in the United States is included, never the

parent or a foreign affiliate doing business in the United States is one of the questions reserved in *Container*, is now before this Court in this case and continues to be an issue even under the new California legislation. Further, the water's edge election continues to impose discriminatory burdens on electing taxpayers.[7]

The United States completely omits any reference to the other six states that use worldwide combined reporting. The United States also assumes that no other state will adopt the system in the future.[8] In the early 1970's when this issue began, only three states (California, Oregon and Alaska) utilized worldwide combined reporting. In addition to the states now using worldwide combination, other states employ "domestic" combined reporting but may include unitary foreign corporations doing business in the United States in the combined report on a worldwide basis.[9]

If this Court fails to determine this case now, there is no barrier to any state adopting worldwide combined reporting. In fact the decision of the California Supreme Court stands as an encourage-

entire income of the corporation. Respondent has also rejected federal and treaty limitations on the source of income of such a foreign corporation, another nonconformity. *See* Cal. Code Regs. tit. 18, §§ 25110(d)(2)(G)(i) and (ii) (1992).

[7]To elect a taxpayer must agree to include dividends received from "significant" (15%) suppliers and customers in its California tax base. Cal. Rev. & Tax. Code § 25110(b)(2)(B)(ii); *compare Allied-Signal, Inc. v. Director, Div. of Taxation*, 357 U.S. 28 (1992). *See also Kraft Gen. Foods, Inc. v. Iowa Dep't of Revenue and Fin.*, ____ U.S. ____, 112 S. Ct. 2365 (1992). Taxpayers also face immediate tax on otherwise deferred offshore intercompany transactions not in the water's edge when they elect. How the legislation will be applied, particularly with respect to compliance burdens, remains of concern. Compliance burdens associated with worldwide combined reporting are an ongoing source of international irritation and their constitutionality is a separate issue in this case.

[8]Future adoption which compounds proliferation is a constitutionally significant concern. *See Japan Line, Ltd. v. County of Los Angeles*, 441 U.S. 434, 453 (1979).

[9]Arizona, Illinois, New Hampshire and New Mexico.

ment to do just that.[10] The United Kingdom is retaining its retaliatory legislation against this possibility. Pet. Supp. App. P.

II.

This Case Involves An Issue Of An International Standard. Only The Nation, Not A State, Can Provide A National Solution.

In its second argument the United States posits the unique contention that national regulation of foreign commerce is well served by a single state's unilateral determination of an acceptable prospective alternative to its basic and constitutionally violative system. This argument is completely contrary to the purposes and policies animating the dormant foreign Commerce Clause.

As this Court has said:

> The few simple words of the Commerce Clause . . . reflected a central concern of the Framers that was an immediate reason for calling the Constitutional Convention: the conviction that in order to succeed, the new Union would have to avoid the tendencies toward economic Balkanization that had plagued relations among the Colonies and later among the States under the Articles of Confederation.

Hughes v. Oklahoma, 441 U.S. 322, 325-326 (1979). *See also Wardair Canada, Inc. v. Florida Dep't of Revenue*, 477 U.S. 1, 7-8 (1986). To propose that a state determine how it will resolve its use of an international tax system clearly inconsistent and incompatible with that used by both the United States and its trading partners invites exactly the economic Balkanization feared by the Framers. Who is the "voice of the United States" among this babble of the states? Are North Dakota and Tennessee now to be invited to propose their solutions?

The United States had it right the last time:

> The Commerce Clause recognizes that there are matters affecting our foreign commercial relations that inherently require a national solution so that the United States may speak with one voice in its dealings with other Nations. That Congress has not yet crafted a solution to the problem does not mean that the choice of solutions has been left to the separate action of the several States. *See Container Corp. v. Franchise Tax Board*, 463 U.S. at 194.

Am. U.S. Br. No. 92-212 (Pet. Supp. App. K p. A15).

The Member States of the European Community have already informed the United States that a "California solution" is insufficient. They rightfully continue to seek a solution from the Nation, not a piecemeal approach by the states. Pet. Supp. App. Q. Acceptable variations to the international standard are questions to be agreed upon by nations, not unilaterally adopted, even with the United States Executive's blessing, by a state.

The United States' argument has familiar resonances:

> The Solicitor General, as *amicus curiae*, says that the Government does not "contend that the application of the Oregon escheat statute in the circumstances of this case unduly interferes with the United States' conduct of foreign relations." But that is not the point. We deal here with the basic allocation of power between the States and the Nation. Resolution of so fundamental a constitutional issue cannot vary from day to day with the shifting winds at the State Department. Today, we are told, Oregon's statute does not conflict with the national interest. Tomorrow it may. But, however that may be, the fact remains that the conduct of our foreign affairs is entrusted under the Constitution to the National Government, not to the probate courts of the several States.

Zschernig v. Miller, 389 U.S. 429, 443 (1968) (Stewart, J., concurring).

III.

California's Legislation Provides No Accommodation Of The Affected Interests.

The United States mysteriously hints that further review of this case could "potentially destabilize" an "accommodation" of state, national and international interests reached on this issue.

There is no accommodation of the foreign taxpayers' interest in one billion dollars of back taxes and assessments which stand to

[10]The California Supreme Court's opinion created a new test for congressional acquiescence to state action in Congress' failure to act while "aware" of the problem from its reading of a "trend" in this Court's decisions. *Compare* Pet. App. C with App. A and App. B. The lower California courts had found no such "trend." State courts struggling with the issues of federal/state relations need guidance from this Court on the proper application of this Court's decisions.

be collected under an unconstitutional taxing scheme. There is a continuing constitutional violation.

There is no accommodation reached with the foreign governments. The trading partners of the United States continue to request a national solution.

And the Constitution does not "accommodate" the state[11] in the sensitive area of foreign affairs and commerce:

> For local interests the several States of the Union exist, but for national purposes, embracing our relations with foreign nations, we are but one people, one nation, one power.

The Chinese Exclusion Case, 130 U.S. 581, 606 (1889).

At stake here is sixty years of cooperation among nations to achieve a uniform national response to the division of income for tax purposes among such nations. "Destabilization" will occur only if this Court fails to take this case.

The application of worldwide combined reporting by states of this Nation to foreign multinationals for the past twenty years has led this Nation to the brink of a trade war. It has taken the Petitioner nine years to move this case through the California court system. The case is fully justiciable. The issue is ripe. This Court should provide a national solution here and now.

Respectfully submitted,

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[11]The federal/state accommodation seems to permit the State to keep the one billion dollars at issue here in taxes and fees while providing $2.3 billion of tax relief to California companies.

Appendix K

No. 92-212

In the Supreme Court of the United States

OCTOBER TERM, 1992

BARCLAYS BANK PLC, PETITIONER

v.

FRANCHISE TAX BOARD, AN AGENCY OF THE STATE OF CALIFORNIA

ON PETITION FOR A WRIT OF CERTIORARI TO THE SUPREME COURT OF THE STATE OF CALIFORNIA

BRIEF FOR THE UNITED STATES AS AMICUS CURIAE
IN SUPPORT OF PETITIONER

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QUESTION PRESENTED

Whether, as applied (i) to a domestic corporation that has a foreign parent or (ii) to a foreign corporation that has a foreign parent or foreign subsidiaries, California's use of the worldwide formula apportionment method to allocate income for tax purposes violates the Commerce Clause of the Constitution.

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INTEREST OF THE UNITED STATES

The Constitution confers upon Congress the power to "regulate Commerce with foreign Nations" (Art. I, § 8, Cl. 3) and authorizes the President, "by and with the Advice and Consent of the Senate, to make Treaties" (Art. II, § 2, Cl. 2). The United States has a substantial interest in cases that address the constitutional allocation of authority over matters affecting foreign commerce and foreign relations. This case presents such an issue.

As this Court recognized in *Container Corp. v. Franchise Tax Board*, 463 U.S. 159, 184-193 (1983), the United States employs the arm's length method for allocating income among commonly controlled corporations. This method, which reflects the consistent practice of all major trading Nations, is also required, for federal taxation, by numerous tax treaties to which the United States is a party. California's use of the worldwide combined reporting method for allocating income among a unitary group of multinational corporations conflicts with this uniform international practice and has created an irritant in the commercial relations of the United States and its major trading partners. The Departments of State and Treasury inform us that foreign governments have objected to California's departure from accepted international tax practice and have threatened (or enacted)

retaliatory legislation against United States corporations as a result of California's unilateral actions. The State's tax has thus seriously undermined the federal government's ability to "speak with one voice when regulating commercial relations with foreign governments." *Michelin Tire Corp. v. Wages*, 423 U.S. 276, 285 (1976).

STATEMENT

1. Two different methods have been used to identify and allocate among taxing jurisdictions the income received by multinational corporations. The method employed by the United States is known as the "separate accounting" or "arm's length" method. This method generally treats each corporation as a distinct tax unit, doing business with every other corporation (including its parent, subsidiaries or affiliates) on an arm's length basis. The separate accounting method of taxation is employed in the Internal Revenue Code and is a central feature of the many bilateral tax treaties to which the United States is a party (Pet. App. F44). The separate accounting method is also the accepted international standard.[1] It is almost universally applied by foreign tax systems and has been incorporated in the model tax treaties adopted by the United Nations and the Organization for Economic Cooperation and Development (*ibid*).[2]

[1]The international practice is described in the letter to Governor Deukmejian of California, dated January 30, 1986, from Secretary of State George P. Shultz (Pet. App. F44-F46). See also G. Maisto, *General Report*, in 77a *International Fiscal Ass'n, Cahiers de droit fiscal international (Transfer Pricing in the Absence of Comparable Market Prices)* 19-75 (1922). Maisto notes that the arm's-length method is the primary method for allocating income internationally and that the OECD considers the combined reporting and formula apportionment method of allocating income to be arbitrary. *Id.* at 50-51. Other than in a few States of the United States, the worldwide combined reporting method is not used at the national or sub-national level by the United States or any of its major trading partners or in any of the countries surveyed. *Ibid.*

[2]See OECD Model Double Taxation Convention on Income and on Capital, Art. 7 (1977); Organization for Economic Cooperation and Development Committee on Fiscal Affairs, *Transfer Pricing and Multinational Enterprises* (1979); United Nations Model Double Taxation Convention Between Developed and Developing Countries, U.N. Pub. No. ST/ESA/102, Art. 7 (1980).

The other method of allocating corporate income among taxing jurisdictions is the "worldwide combined reporting" method used by California and two other States. For corporations engaged in a unitary business, California ignores the separate corporate existence of parents, subsidiaries and affiliates, pools their income together, and allocates a portion of that combined income to California based upon a multi-factor apportionment formula.[3] See *Container Corp.* v. *Franchise Tax Board*, 463 U.S. 159, 162-163 (1983). California applies its worldwide combined reporting method not only to domestic parent corporations that have foreign subsidiaries (see *ibid.*) but also to domestic subsidiaries (conducting business in California) that have foreign parents and to foreign parents (conducting business in California) that have foreign subsidiaries.

California's application of the worldwide combined reporting method of taxation to corporations doing business in California that have foreign parents or foreign affiliates conflicts with the "separate accounting" method applied under federal law and under established international practice. In letters addressed to the governors of the six States that then employed the worldwide combined reporting method of taxation. (Alaska, California, Idaho, Montana, New Hampshire and North Dakota), the Secretary of State expressed the concern of the United States that state use of worldwide combined reporting "is at odds with the position of the United States and has become a source of conflict with foreign states" (Pet. App. F45). The Ambassadors of Australia, Belgium, Canada, Denmark, France, the Federal Republic of

[3]Under the three-factor apportionment formula used by California, the in-state corporation's income is calculated as a percentage of the total income of the group of related corporations. After the unitary business group is identified, the in-state corporation's sales, property, and payroll are expressed as a fraction of the total sales, property, and payroll of the unitary group. These three fractions are arithmetically averaged. This average is then multiplied against worldwide group income to yield the taxable income of the in-state corporation (Pet. App. A5).

Germany, the United Kingdom, Greece, Ireland, Italy, Japan, Luxembourg, the Netherlands and Switzerland have advised the United States that the worldwide combined reporting method of taxation constitutes "a serious obstacle to the further development of our trade and investment relationships" (Pet. App. F45). In particular, the United Kingdom enacted legislation in 1985 that provides for retaliatory tax treatment of United States corporations that operate in the States that apply the worldwide combined reporting method.[4] While the United Kingdom has not yet invoked this legislation,[5] its enactment provides clear indication of the adverse impact that California's method of taxation has on the conduct of foreign economic relations by the United States.

2. The taxpayers involved in this case are Barclays Bank International Limited (BBI) and Barclays Bank of California (Barcal). During 1977, Barcal (a United States corporation conducting banking activities in California) was a wholly owned subsidiary of BBI (a United Kingdom corporation conducting an international banking business).[6] Both BBI and Barcal did business in California and were therefore subject to tax in that State (Pet. 3, 4; Pet. App. C36-C38).

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[4]The United Kingdom legislation denies tax credits on the taxes owed by such corporations for dividends they receive from their United Kingdom subsidiaries. See Finance Act 1985, Pt. II, ch. I, § 54, and Sch. 13, ¶ 5 (Eng.), reenacted without substantial change in Income and Corporation Taxes Act 1988, Pt. XVIII, ch. III, § 812 and Sch. 30, ¶¶ 20 and 21 (Eng.). See also Parliamentary Debates (Hansard) 1014-1018 (10 July 1985); Secretary of State Shultz's letter to Governor Deukmejian (Pet. App. F46).

[5]The United Kingdom has stated that the legislation will not apply to dividends paid on or before December 31, 1989. See Joint Report by Inland Revenue and U.S. Treasury, *Unitary Tax: Review of Progress Towards Resolving the Problems*, para. 6.2 (Dec. 1991).

[6]BBI was a wholly owned subsidiary of Barclays Bank Limited, a United Kingdom corporation. In 1982, Barclays Bank Limited changed its name to Barclays Bank PLC, which is named as the petitioner in this case (Pet. 2-3).)

In computing its California income tax for 1977, Barcal used the separate accounting method and reported only the income it earned from California sources. In computing its California income tax for 1977, BBI reported not only the income it earned from California sources but also included (i) income BBI earned from operating bank agencies and branches in the United Kingdom and approximately 33 nations or territories outside of the United Kingdom and (ii) the income earned by 70 subsidiaries (including Barcal) of BBI operating in 34 nations or territories outside of the United Kingdom. BBI did not, however, include the income of BBI's parent (see note 6, *supra*) or of the parent's subsidiaries. Thus, neither Barcal nor BI submitted its California tax return under the worldwide combined reporting method required by California (Pet. 7-8; Pet. App. C38-C41).

The California Franchise Tax Board determined that Barcal and BBI were members of a worldwide unitary business conducted by all members of the Barclays Group. That Group included (i) Barcal, a wholly owned subsidiary of BBI doing business only in California; (ii) BBI, A United Kingdom Corporation doing general retail and commercial banking in the United Kingdom and 34 other nations or territories outside the United Kingdom, including California; (iii) the subsidiaries of BBI in which BBI has more than a 50% interest; (iv) Barclays Bank Limited, a United Kingdom corporation which conducts no business in California and which owns 100% of the stock of BBI; and (v) the subsidiaries of Barclays Bank Limited in which that corporation holds more than a 50% interest. The California Franchise Tax Board calculated the tax owed by BBI and Barcal by allocating a portion of the total income of the above unitary group to these two taxpayers utilizing a three-factor apportionment formula. The State's calculation indicated a tax deficiency, which the Board then assessed (Pet. 7-8; Pet. App. C38-C40).

3. Barcal and BBI challenged the State's assessment because it was based not only on the income that they had separately earned but also on the income of their foreign parent and other related foreign subsidiaries which do no business in California or elsewhere in the United States. After paying the assessments, the taxpayers sued for a refund in California superior court (Pet. App. C38-C41).

The trial court entered judgment in favor of the taxpayers (Pet. App. C1-C34). The court concluded that California's computation of taxes by use of worldwide combined reporting improperly included income earned by foreign parents and affiliates of the taxpayers. The court held that this violated the Commerce Clause of the United States Constitution because it impeded the federal government's ability to speak with one voice in the conduct of foreign affairs (*id.* at C23-C26), impermissibly discriminated against foreign commerce (*id.* at C26-C28) and violated due process (*id.* at C29-C30).[7]

The California court of appeal affirmed (Pet. App. B1-B37). The appellate court held that California's application of worldwide combined reporting to the income received by foreign parents and affiliates of the taxpayers violated the Commerce Clause because it frustrated the United States' ability to speak with one voice in an area of foreign affairs where federal uniformity is necessary (*id.* at B35).

The California Supreme Court reversed, upholding the constitutionality of the tax under the Commerce Clause as applied in this case. The court relied extensively on the fact that, while Congress has been given many opportunities, it has not enacted legislation to prohibit the States from employing the worldwide combined reporting method to multinational corporations (Pet. App. A28-A31). Concluding from "the din" of this legislative "silence" that Congress "has decided *not* to prohibit state use" of worldwide combined reporting "in cases of this kind" (*id.* at A26), the court declined to apply the Commerce Clause to prohibit the State from enforcing a tax that Congress has not acted affirmatively to prohibit (*id.* at A24-A38).

Since the court of appeal had resolved the case solely under the Commerce Clause, and had not reached petitioner's separate due process challenge to the State's tax (see note 7, *supra*), the

[7]The trial court concluded that procedures adopted to implement the State's worldwide combined reporting method violate due process because, "with customarily and currently available acounting [sic] data, literal compliance with [their] requirements is impossible for foreign multi-nationals" (Pet. App. C29).

California Supreme Court remanded the case to the court of appeal for further proceedings on that issue (*id.* at A39-A40).

ARGUMENT

In *Container Corp.* v. *Franchise Tax Board*, 463 U.S. 159 (1983), the Court held that California's use of the worldwide combined reporting method for allocating the income of a unitary business did not violate the Commerce Clause. *Id.* at 184-197. That case, however, concerned application of the worldwide combined reporting method to a domestic parent corporation doing business in California. Recognizing the potentially different and additional considerations involved when the incidence of a state tax falls on a *foreign* corporation, the Court expressly reserved the question whether the California method would be constitutional "with respect to state taxation of domestic corporations with foreign parents or foreign corporations with either foreign parents or foreign subsidiaries." *Id.* at 189 n.26.

This case presents the question that was expressly reserved in *Container Corp.* This Court's resolution of this important question is necessary to avoid continued state action that conflicts with accepted international commercial practice and prevents the United States "from speaking with one voice when regulating commercial relations with foreign governments" (*Japan Line, Ltd.* v. *County of Los Angeles*, 441 U.S. 434, 451 (1979)).

1. Under the Commerce and Due Process Clauses of the United States Constitution, a State, when imposing an income-based tax, may not tax value earned outside its borders. *Allied-Signal Inc.* v. *Director, Division of Taxation*, 112 S. Ct. 2251, 2255, 2258 (1992). The State may, however, constitutionally tax on an apportioned basis the income earned by a corporation in multiple taxing jurisdictions. *Container Corp.* v. *Franchise Tax Board*, 463 U.S. at 164-165. The income to be apportioned must, however, be related to the business carried on in that State. *Allied Signal, Inc.* v. *Director, Division of Taxation*, 112 S. Ct. at 2263. For a tax imposed on an apportioned basis to satisfy the basic requirements of the Commerce Clause, (i) there must be a substantial nexus between the State and the activity or property taxed, (ii) the activity or property must be fairly apportioned to

the taxing State, (iii) the tax must not discriminate against interstate commerce, and (iv) the tax must be fairly related to the services provided by the State. *Wardair Canada Inc.* v. *Florida Department of Revenue*, 477 U.S. 1, 8 (1986); *Container Corp.* v. *Franchise Tax Board*, 463 U.S. at 165-171. When the state tax affects foreign commerce, two additional questions must be addressed: "first, whether the tax, notwithstanding apportionment, creates a substantial risk of international multiple taxation, and, second, whether the tax prevents the Federal Government from speaking with one voice when regulating commercial relations with foreign governments." *Wardair Canada Inc.* v. *Florida Department of Revenue*, 477 U.S. at 8 (quoting *Japan Line, Ltd.* v. *County of Los Angeles*, 441 U.S. 434, 451 (1979). See also *Container Corp.* v. *Franchise Tax Board*, 463 U.S. at 185-187. "If a state tax contravenes either of these [two additional] precepts, it is unconstitutional under the Commerce Clause." *Japan Line, Ltd.* v. *County of Los Angeles*, 441 U.S. at 451.

The Court observed in *Container Corp.* that "a state tax at variance with federal policy will violate the 'one voice' standard if it *either* implicates foreign policy issues which must be left to the Federal Government *or* violates a clear federal directive." 463 U.S. at 194. The "most obvious foreign policy implication of a state tax is the threat it might pose of offending our foreign trading partners and leading them to retaliate against the Nation as a whole." *Ibid.*

In *Container Corp.*, this Court considered the constitutionality of California's application of the worldwide combined reporting method to determine the income of members of a unitary corporate group controlled by a domestic parent corporation. Noting that the United States had not filed a brief in that case (463 U.S. 195-196 and n.33)[8] and that there was no suggestion that foreign

[8]At the time *Container Corp.* was considered by the Court, there was another case (*Chicago Bridge & Iron Co.* v. *Caterpillar Tractor Co.*, No. 81-349) before the Court that presented virtually the same issue. The United States had submitted an amicus brief and participated in the oral argument in *Chicago Bridge*, taking the position that a similar Illinois tax involving a domestic corporation with foreign subsidiaries violated the Commerce Clause. After argument, the Court ordered

retaliatory acts would stem from California's taxation of domestic parent corporations (*id.* at 195), the Court concluded that California's tax as applied to members of domestic multinational corporations did not seriously threaten the foreign policy of the United States and thus did not violate the Commerce Clause. The Court, however, recognized that the result may be different when the "incidence of the tax" (*ibid.*) falls on a foreign-controlled corporation. See *id.* at 188. The Court therefore expressly reserved judgment as to whether the tax would be constitutional as applied to members of a foreign-controlled corporate group. *Id.* at 189 n.26.

When, as in the present case, the State applies its worldwide combined reporting method to compute the state income tax of members of a foreign unitary corporate group, application of the tax creates an impediment in the relations of the United States with its trading partners and implicates foreign commerce concerns that are the exclusive province of the federal government. As this Court recognized in *Container Corp.*, 463 U.S. at 184-193, the arm's-length standard is the international norm for allocating income among controlled corporations across international boundaries and the method used by the United States for allocating income for federal income tax purposes. The method used by California is at odds with this accepted international practice. California's use of its inconsistent method of taxation has created serious tensions in the federal government's conduct of commercial relations with its trading partners and led to the enactment of retaliatory legislation (Pet. App. F44-F47). See p. 5, *supra*. California's application of its worldwide combined reporting method of taxation to compute the income tax of members of foreign-controlled unitary corporate groups violates the Commerce Clause under this Court's analysis in *Container Corp.* because California's unilateral action departs from an accepted international practice to which the United States adheres and prevents the United States from speaking with one

Chicago Bridge carried over to the next Term, but did not schedule that case for reargument. Instead, it scheduled and heard argument in *Container Corp.* The Members of the Court disagreed as to what position the United States took with respect to *Container Corp.* See 463 U.S. at 195-196 & n.33; *id.* at 204 (Powell, J., dissenting).

voice on this sensitive and important matter of foreign commercial relations. See 463 U.S. at 185-189, 193-196.

2. The California Supreme Court did not test California's method of apportioning income in this case under the analysis set forth in *Container Corp.* because the court concluded (Pet. App. A39) that *Wardair Canada Inc.* v. *Florida Department of Revenue* imposed a new, preliminary hurdle to the taxpayers argument. *Wardair* involved a challenge by a Canadian-based international air carrier to a state sales tax on fuel purchased in Florida for flights operating between Florida and Canada. The Court found "no threat of multiple international taxation * * * since the tax [was] imposed only upon * * * a discrete transaction which occurs within one national jurisdiction only" (477 U.S. at 9). Nor did the Court find any evidence that imposition of the sales tax in that case violated any international norm. *Id.* at 10. To the contrary, the Court concluded that numerous bilateral agreements to which the United States was a party were "understood * * * to permit this sort of taxation" and therefore "show that the Federal Government has affirmatively decided to permit the States to impose these sales taxes on aviation fuel." *Id.* at 12. Finding such "affirmative[ ]" approval of the state tax, the Court found "no need * * * to consider * * * whether, in the absence of these international agreements, the Foreign Commerce Clause would invalidate Florida's tax." *Id.* at 13.

California claims that this case is like *Wardair* because the United States is a party to numerous bilateral tax treaties that set forth agreements with respect to national-level taxation but do not address state or sub-national taxation (Pet. App. A34). California relies specifically on the history of the 1975 tax convention between the United States and the United Kingdom (*id.* at A30-A31). As originally presented to the Senate for advice and consent to ratification, that treaty contained a provision (Article 9(4)) that required sub-national taxation to be consistent with the arm's length standard. See Convention Between United States and United Kingdom for Avoidance of Double Taxation, Dec. 31, 1975, 31 U.S.T. 5670, 5677, T.I.A.S. No. 9682. Although a majority of the Senate voted in favor of the treaty, less than the required two-thirds of the votes were obtained for ratification. 124 Cong. Rec. 18,669-18,670 (1978). In a subsequent vote, however, the treaty was approved subject to a reservation that Article 9(4)) [sic] would not apply "to any political subdivision or local authority of the United States" (*id.* at 18,416). See *id.* at 19,076. The California Supreme Court concluded from this history (Pet. App. A29-A30) that the Senate's action represents "affirmative" approval of the California tax under the analysis of this Court in *Wardair*.

The contrasts between this case and *Wardair* are striking. In *Wardair,* the Court found that numerous treaties had been made that were "understood" by the participants "to permit" state sales taxation to proceed. 477 U.S. at 12. That "understanding" was supported by the fact that there was no international norm precluding that type of state taxation. *Id.* at 10-11. In this case, by contrast, there is a well-established international practice precluding the State's contrary tax system, a practice that the Executive has steadfastly honored and that a majority of the Senate voted to implement. Far from representing acquiescence through silence, this history of Executive and Senate action reflects the thoroughly national character of this issue and the need for federal-level, rather than state-level, disposition of the matter.

Unless this Court concludes that a minority of the Senate can determine the "affirmative" policy of the federal government, it cannot conclude that Senate action on federal tax treaties exhausts the scope of the national power to regulate foreign commerce. The Commerce Clause recognizes that there are matters affecting our foreign commercial relations that inherently require a national solution so that the United States may speak with one voice in its dealings with other Nations. That Congress has not yet crafted a solution to the problem does not mean that the choice of solutions has been left to the separate action of the several States. See *Container Corp.* v. *Franchise Tax Board,* 463 U.S. at 194.[9]

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[9]In *Container Corp.*, the Court reviewed much of the same treaty history and legislative proposals considered by the California Supreme Court in this case. See 463 U.S. at 196-197. The Court noted that Congress has "long debated, but has not enacted, legislation designed to regulate state taxation of income." *Id.* at 197 (quoting *Mobil Oil Corp.* v. *Commissioner,* 445 U.S. 425, 448 (1980)). As a result, the Court concluded that there was no "explicit directive" (463 U.S. at 197)

This Court's resolution of the question presented in this case is of great importance because the analysis applied by the California Supreme Court threatens broad impact on the constitutional allocation of authority to the federal government to regulate foreign commerce. Treaties often may stop short of addressing all aspects of commercial relations. Congress may also decline to enact legislative proposals disposing of similar problems. The fact that treaties and legislation have not provided a binding solution does not mean that the States are empowered independently to resolve politically sensitive matters affecting our international commercial relations.

CONCLUSION

If the Court concludes that it has jurisdiction (see Pet. 26-28), the petition for a writ of certiorari should be granted.

Respectfully submitted.

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August 1992

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limiting the State's ability to assess the tax at issue in *Container Corp.* That conclusion, however, did not remove the necessity of also considering whether the State's tax was unconstitutional because it would interfere with the conduct of foreign relations and prevent the federal government from speaking with one voice in the regulation of foreign commerce. See *id.* at 194-196. To the contrary, the Court made clear that *both* inquiries were necessary. See *ibid.*

Appendix L

THIRD READING

SB 671
Alquist(D) et al
9/10/93

SUBJECT: Taxation: unitary and income tax—water's edge: business expenses

SOURCE: The author

DIGEST: This bill permits multinational corporations to use the "water's edge" accounting method to determine its California tax liability without paying an election fee. It also changes the reporting requirements for all corporations. Reduced the State Bank and Corporation deductibility for business meals and entertainment from the current 80 percent of costs to 62 percent.

Senate Floor Amendments of 8/30/93 delete the federal conformity provisions for the personal income tax concerning meals and entertainment. Deletes the club dues denied from both bank and corporation and personal income tax law. Retains the business meals and entertainment expense conformity at a 62 percent level rather than at 50 percent for the State Bank and Corporations Tax.

Assembly Amendments:

1. Modify the unitary method of income apportionment provisions already in the bill.
2. Establish a 6 percent tax credit for manufacturing equipment.
3. Exempt from tax 50 percent of the capital gain realized from the sale of qualified small business stock held for 5 or more years.
4. Reduces from 80 percent to 50 percent the percentage of business meals and entertainment which may be deducted as a business expense.
5. Reduces from 2.5 percent to 1.5 percent the tax rate applied to Subchapter S Corporations.

6. Place a sunset date on sales tax exemptions for space flight material used in a launch at Vandenberg Air Force Base of January 1, 2004.

7. Make the Research and Development credit permanent by deleting the January 1, 1998 sunset date.

For details of each one of the above, see attached Senate Revenue and Taxation Committee analysis.

SUPPORT: (Verified 8/25/93)

California Manufacturers Association
California Chamber of Commerce
California Taxpayers Association
Franchise Tax Board

ARGUMENTS IN SUPPORT: Proponents state, "SB 671 is intended to make changes to California's method of taxing corporate income. Changes are required by September 10 to improve California's business climate and avoid an international tax war.

"California companies and those engaged in business here wish to avoid retaliation by the foreign governments. The provisions provided in SB 671, as amended, is an acceptable resolution for the business community.

"A broad coalition of business groups supports this course of action. Also, the Franchise Tax Board has adopted a very similar position.

"If these changes are made, the associations support a revenue neutral bill using revenue raised from adopting recent federal tax changes. If this legislation is approved by September 10, we believe it will meet the needs of our foreign trading partners for a more equitable system of taxation."

The business community supports the other provisions which they believe will simulate [sic] economic growth.

SB 671—Alquist
(amended 9/9/93)

SUBJECT: Personal Income Tax, Bank & Corporation Tax, Sales Taxes: Unitary method of apportionment, 6% manufacturing credit, reduction in Sub S rate, Exemption for start-up manufacturers and space launches from Vandenburg [sic], conforms with business meal deductions and small business incentives, changes research & development base and removes sunset on credit

AS PASSED BY THE SENATE SB 671:

—deleted the requirement that firms making the water's-edge election file a domestic disclosure spreadsheet

—removed the FTB's authority to disregard a water's edge election

—repealed the election fee for a water's-edge election

—reduced the business meals deduction for corporate taxpayers from 80% of cost to 62% of cost

AS PASSED BY THE ASSEMBLY SB 671 contains the following provisions:

1. *Unitary method of income apportionment*. The bill deletes the requirement to file the domestic disclosure spreadsheet for firms making the water's-edge eledtion [sic] and replaces this requirement with a minimal reporting requirement for firms with over $200 million in assets.

It eliminates FTB's authority to "disregard' a water's-edge election. In place of this authority, the bill requires taxpayers to provide specified audit information. Taxpayers failing to provide that information would be subject to a substantial penalty.

SB 671 repeals the election fee for taxpayers filing their return on a water's edge-basis. The repeal is effective for income years beginning on or after January 1, 1994.

2. *Credit for manufacturing equipment*. SB 671 establishes a tax credit equal to 6% of qualified manufacturing equipment

placed in service after January 1, 1994. The credit could be claimed beginning with the 1995 tax year.

The credit would be available for property used primarily in manufacturing, research and development, or the repair and maintenance of qualified equipment. Qualified equipment is depreciable property as defined in Section 1245 of the Internal Revenue Code. However, the credit could be claimed for special purpose buildings and foundations that do not meet the Section 1245 criteria if they are used by biotech firms and manufacturers of office, computing, and accounting machines as well as manufacturers of electronic components and accessories.

The credit could be claimed against both the regular tax and the alternative minimum tax. Unused credits could be carried forward to offset future tax liabilities for up to 8 years (10 years for "small" firms.)

The credit would sunset January 1, 2001, if manufacturing employment—other than aerospace employment—does not increase by 100,000 jobs during the period between January 1, 1994 and January 1, 2001.

Instead of this credit, a start-up firm has the option of a 6% sales tax exemption on manufacturing equipment during its first three years of operations.

3. *Small business stock capital gains.* This bill exempts from taxation 50% of the capital gain realized from the sale of qualified small business stock held for 5 or more years. For a stock to be eligible for this income exclusion, it must meet the following criteria:

—The stock must be originally issued after August 10, 1993 and before December 31, 1998 by a company doing business in California which has less than $50 million in gross assets. At least 80% of the qualifying company's payroll must be attributable to employment located in California.

—The issuing company cannot be engaged primarily in the performance of specified services including: health, law, engineering, accounting, performing arts, or consulting. Banking, insurance, farming, oil and gas extraction, hotel, and restaurant business are also ineligible.

4. *Business Meals.* SB 671 reduces from 80% to 50% the percentage of business meals and entertainment which may be deducted as a business expense. This changes [sic] is consistent with recent federal tax law changes.

5. *Subchapter S.* This bill reduces from 2.5% to 1.5% the tax rate applied to Subchapter S corporations.

6. *Space Flight Material.* Space flight material used in a launch at Vandenburg [sic] Air Force Base would be exempt from state and local taxes. This exemption sunsets January 1, 2004.

7. *Research and Development Credit.* This bill makes the credit permanent by deleting the January 1, 1998 sunset date. In addition, it replaces the state's "three-year rolling average" method of calculating the crredit [sic] with the federal "fixed base" method.

FISCAL EFFECT: (Franchise Tax Board)

	93–94	94–95	95–96	96–97	97–98	98–99	99–00
Unitary	$–15	–60	–75	–80	–80	–80	–80
Investment Credit		–125	–406	–373	–375	–375	–375
Business Meals	+40	+140	+150	+160	+160	+160	+160
Sub S Reduction	–30	–70	–78	–80	–80	–80	–80
Sm. Bus. Investment						–15	–26
Research & Devt	–22	–45	–50	–60	–60	–200	–200
Space Launches		–7	–15	–15	–15	–15	–15
	$–27	–167	–474	–448	–450	–605	–616

1. Unitary Method of Income Apportionment

EXISTING LAW (Bank and Corporation Franchise Tax Law) imposes a tax on corporations doing business in California. The tax is technically a "franchise tax" on the privilege of doing business as a corporation in California, and is "measured by" the amount of income derived from California activities; the tax is imposed at a rate of 9.3%, with a minimum tax of $800.

If a corporation is engaged in a business which is conducted both within and without California, that business is considered a "unitary business," and the amount of income subject to tax in California is determined by a formula based on the average percentage of payroll, property and sales in California as com-

pared with total payroll, property and sales for the entire business, nationwide or worldwide. This is known as "formulary apportionment."

> For example, if the corporation's California payroll, property and sales are 20%, 25% and 30%, respectively, of the payroll, property and sales for the entire business, worldwide, then 25% (the average of 20, 25 and 30) of the net income of the business would be subject to California's 9.3% tax rate.

If a commonly owned or controlled group of corporations conducts a unitary business both within and without California, then the group must file a "combined report" with FTB which includes the California payroll, property and sales factors for all of the corporations combined. The share of the unitary group's income which is subject to California's 9.3% tax rate is based on each taxpayer's California payroll, property and sales as a percentage of the group's nationwide or worldwide payroll, property and sales as shown on the group's combined report. When foreign operations are included in a combined report, it is called "worldwide combination."

Since 1988, an alternative method has been available for determining California's share of a worldwide unitary business—the so-called "water's edge" method. Under water's edge (enacted by SB 85 (Alquist—1986)), a worldwide group of commonly owned or controlled corporations conducting a unitary business may elect to have formulary apportionment apply only with respect to those operations which are within the "water's edge." In other words, only those corporate affiliates which are defined to be within the United States water's edge must be included in the combined report; foreign affiliates are not included in the report.

In order to compute tax on a water's edge basis, the members of the unitary group must agree to pay an election fee equal to 0.03% (three hundredths of one percent) of the sum of their 1986 payroll, 1986 property, and current-year sales in California, reduced by increases in investment and payroll since 1986. The election period is a minimum of five years.

In addition, corporate groups electing water's edge must agree to provide FTB, every three years, with a "domestic disclosure

spreadsheet" showing the income and tax liability reported to each state, the method of apportioning income to each other state, a list of affiliated corporations, and other information as required by FTB regulation.

Finally, if a taxpayer electing water's edge willfully refuses to file the spreadsheet or other necessary audit information, or if FTB determines that evasion of taxes cannot be prevented with the audit tools available, then the FTB may "disregard" (or revoke) the water's edge election, thus throwing the taxpayer back under the worldwide combination method.

Note that the election fee, the domestic disclosure spreadsheet, and FTB's ability to disregard the election have been the subject of much dispute since passage of SB 85 in 1986. Many taxpayers, most notably British corporations, have strenuously objected to these features of our water's edge method, arguing that water's edge, and the accompanying "direct accounting" method, conform with international standards of taxation, and that California's divergence from these standards is offensive to them. (Note, however, that a number of corporations continue to prefer filing under the old worldwide combination method, since their tax liability is lower under that method.)

THIS BILL would *repeal the current election fee* for those desiring to use the water's edge method, and would extend the current five-year contract period to seven years.

The bill would also *repeal the present domestic disclosure spreadsheet* requirement for companies electing water's edge, and would substitute an information return containing a list of the corporation's affiliates. Whereas the current spreadsheet is required of all large corporations which elect water's edge, the proposed list-of-affiliates requirement would apply to all large corporations.

FTB believes that the list of affiliates is the most useful of the information currently required as part of the spreadsheet; they also believe that this information is readily available, unlike much of the presently required spreadsheet information. The information return would be due in the year of first election to water's edge, and would subsequently be due every three years.

And the bill would *remove FTB's ability to disregard the water's edge election*. In place of the disregard power the bill would require electing taxpayers to maintain and provide on request information necessary to (1) determine the amount of income attributable to the state, (2) classify income as business or nonbusiness income, (3) determine unitary apportionment factors for use within the water's edge, and (4) make audits of attribution of income to the U.S. and foreign countries under certain federal provisions. Failure to comply would result in a substantial penalty (in lieu of the current disregard power): $10,000 for each taxable year for which information is not made available, and another $10,000 for each 30 days (after an initial 90 days) if the taxpayer continues to refuse to provide information. (This penalty is adopted from a similar federal information requirement. It would be limited to a maximum of $50,000 until detailed regulations are adopted by the FTB.) The bill further provides that if information is not provided to FTB, then the income apportioned to California, the classification of business vs. nonbusiness income, the apportionment factors, and certain other information will be determined for the taxpayer by FTB. FTB indicates that the required information is necessary in order to properly audit the complex relationship between the water's edge group and affiliated corporations beyond the water's edge.

The bill is intended to accomplish two objectives. First, it is intended to respond to the British Government's threat of retaliation against states which require multinationals to use the worldwide unitary method by revoking a tax credit previously granted to companies which do business both in Britain and in California. In 1985, the British Parliament added a clause to the Finance Bill which would allow the Government to retaliate unless by an unspecified date the worldwide unitary method had been repealed by the states then using it. This May, in response to the new Clinton Administration's apparent reversal of federal position on the *Barclays* case (see below), Chancellor of the Exchequer Lamont announced that "the Government will have to take retaliatory measures in relation to United States based companies if there is not a satisfactory resolution of the unitary tax problem by the end of the year." Although direct communications with British Government representatives have been few, the best information now available is that a three-part bill (elimination of

the election fee, reform of the spreadsheet requirements and repeal of FTB's disregard power) would be sufficient to avoid retaliation. (It should be noted that the total amount associated with retaliation is well over $1 billion in cost to U.S.-based corporations.)

Second, it is intended that, by removing the threat of British retaliation, the bill would make it possible for the Clinton Administration to file a neutral brief with the Supreme Court with respect to whether the Court should take up the *Barclays* case. Although the Supreme Court has blessed the worldwide unitary method in the past, most notably in the 1983 *Container Corp. v. Franchise Tax Board*, the Court has remained silent on commerce clause questions relating to whether a state could require a foreign-based multinational to file on a worldwide combined basis. The prior Administration had filed a brief with the Supreme Court on behalf of Barclays. But as a presidential candidate, Clinton assured California officials that he would side with the states on the issue.

The threat of retaliation, however, naturally caused a seriously awkward situation for the new Administration, and Treasury representatives have requested that California's law be modified to remove the threat. California officials have been assured that if our law is changed in a manner which will remove the threat, then a neutral brief (to the effect that the Administration does not advise the Court to take up the *Barclays* case) would be filed. The deadline for the Solicitor General to act is apparently September 10.

If the Supreme Court takes up the *Barclays* case and decides in favor of Barclays, the direct result will be that California would owe some $500 million in refunds to taxpayers, and we would NOT collect some $350 million in pending assessments, for a total of about $900 million in real costs and opportunity cost. It is likely that if we are unable to require worldwide combination for foreign-based multinationals, we would be unable to so tax domestic-based multinationals as well. We would then lose an additional $1.2 billion in refund claims and another $1.9 billion in cancellation of pending assessments, for a grand total of $4 billion. (This casts the $60 million annual cost of repealing the election fee in a new perspective.)

2. Credit for Manufacturing Equipment

This bill provides a credit equal to 6% of the cost of eligible manufacturing equipment used by manufacturers. Eligible equipment is depreciable property as defined in Section 1245 of the Internal Revenue Code. Eligible equipment also includes special purpose buildings and foundations used by biotech firms, manufacturers of computers, office and accounting machines, electronic components and accessories.

The credit may be used to reduce regular tax liability or alternative minimum tax liability. Unused credits may be carried forward for 8 years. "Small firms" may carry forward these credits 10 years. "Small firms" are defined as firms which meet one of the following criteria:

—has gross receipts of less than $50 million

—has net assets of less than $50 million

—has a total credit of less than $1 million. This is equal to about $16.7 million in purchases.

This credit is effective for purchases made on or after January 1, 1994 and may be claimed beginning with the 1995 tax year. This means that taxpayers may claim a credit for purchases made both in 1994 and 1995 on their 1995 returns.

This exemption sunsets January 1, 2001 if manufacturing jobs—other than aerospace jobs—do not increase by at least 100,000 during the period between January 1, 1994 and January 1, 2000.

Exemption for New Manufacturers

In lieu of the credit for manufacturing equipment, new manufacturers may claim an exemption from the 6% state portion of the sales tax. New manufacturers are defined as manufacturers in the 2000-3999 SIC Codes in the first 3 years of operation who first commence business on or after January 1, 1994.

Property eligible for the exemption is broader than property eligible for the credit and "includes, but is not limited to"

—machinery & equipment

—computers or other devices used to regulate machiner [sic]

—replacement parts with a useful life of 1 year or more

—property used in pollution control

—special purpose buildings used in manufacturing

—fuels used in manufacturing

The following kinds of property are not eligible for the exemption: furniture, inventory, equipment used to store finished products (e.g., shelving), buildings used as warehouses or property with a useful life of less than one year.

Manufacturers must file an exemption with the retailer at the time of purchase. Manufacturers would be required to pay the sales tax on equipment for which they had claimed an exemption if they remove the property from California within one year or if they use the property for a non-exempt purpose—e.g., purchasing a computer and claiming that it will be used for manufacturing then later using it for payroll and accounting.

This exemption sunsets January 1, 2001 if manufacturing jobs—other than aerospace jobs—do not increase by at least 100,000 during the period between January 1, 1994 and January 1, 2000.

3. Small Business Stock Capital Gains

This bill conforms to the recently enacted federal tax provisions relating to small business investment, but only for investment in small California businesses.

Exclusion from gain. It excludes from income subject to tax 50% of the gain on the sale of certain small business stock if the stock is held for five or more years.

The total amount of gain which can be excluded is equal to the greater of:

—10 times the taxpayer's basis in the stock. (Purchase price is generally the basis)

or

—$10 million in gain. The $10 million limitation is applied on a shareholder by shareholder basis.

One half of any excluded gain is treated as an item of preference for purposes of calculating the alternative minimum tax.

Eligible stock. Stock in qualified small businesses, issued on or after August 10, 1993 and prior to December 31, 1998 at the original issuance of the stock in exchange for money, property other than stock, or compensation for services is eligible for the exclusion. (Note: August 10, 1993 is the date the federal tax bill went into effect.)

Qualified small business. To be eligible for the exclusion, the taxpayer must purchase eligible stock in a business which:

—is a C corporation

—has gross assets of $50 million or less

—uses 80% or more of its gross assets in the active conduct of a trade or business in California

—employs at least 80% of its payroll in California

—holds 10% or less of its assets in real property or stock

Investment in the following kinds of businesses would not qualify for the exclusion:

—Domestic international sales corporations (DISC), regulated investment companies (RIC), real estate investment trust (REIT), real estate mortgage investment conduit (REMIC), possessions corporations (Section 936)

—Performance of services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services, or any trade or business where the principal asset of the trade or business is the skill or reputation of one or more of its employees

—Banking, insurance, leasing, financing, investing, farming, extraction, operation of a hotel, motel, restaurant, or similar business

Partnerships and other restrictions. Gain from the sale of qualified small business stock that is purchased by a partnership,

S corporation, or RIC qualifies for the exclusion if the stock is held by the entity for the minimum 5 years and the partner or shareholder of the entity was a partner or shareholder from the time the stock was acquired until its sale. A partner's or shareholder's ability to exclude gain is limited by the partner's or shareholder's interest in the entity at the time the stock was purchased.

A partnership may distribute qualified small business stock to its partners provided a partner was a member of the partnership when the stock was acquired.

If qualified small business stock is transferred to a partnership and the partnership sells the stock, the gain on the sale will not qualify for the exclusion provided by AB 44.

When qualified small business stock is transferred by gift or death, the recipient is treated as owning the stock in the same manner as the donor.

Stock acquired through the exercise of options, warrants or conversions of convertible debt is treated as acquired at original issue.

A taxpayer is not permitted to exclude gain from the sale of qualified small business stock if the taxpayer held a short position in that stock during the 5-year holding period.

This bill requires that the Legislative Analyst's Office study the effectiveness of the capital gains exclusion and report to the Legislature by December 31, 1996. The study will include:

—the effect on investor decisions and amount of additional investment and jobs which occur

—a listing by industry of investments made

—estimated state and local fiscal impact

4. Business Meals

SB 671 conforms to 1993 federal tax changes by reducing the amount businesses can deduct for business meals and entertainment from 80% of cost to 50% of cost.

5. Subchapter S

Current law conforms with federal provisions allowing certain "small business corporations" (defined as corporations with 35 or fewer shareholders, all of whom must be human beings, and only one class of stock) to be treated as partnerships for tax purposes. Our law diverges from federal law in that there is no federal tax at the corporate level for S corporations, whereas California charges a 2.5% tax on net income of S corporations (compared with the 9.3% tax on ordinary corporations).

The bill would reduce the 2.5% tax on S corporations to 1.5%.

6. Space Flight Material

This bill would exempt property from both the state and local share of the sales tax if it is used in a space flight originating at Vandenburg [sic] Air Force Base from January 1, 1994 through December 31, 2003.

Eligible property includes, but is not limited to:

—orbital space facilities

—space propulsion systems

—space vehicles

—satellites

—space stations

—any component parts

"Material that is not intended to be launched into space" is not exempt.

This exemption would be granted even if the launch is cancelled, postponed or fails.

7. Research and Development Credit

EXISTING LAW provides a tax credit for qualified research and development (R&D) expenses incurred by businesses. The credit is generally 8 percent of the increase in research and development expenses above the *average of the prior three years' R&D expenditures.* The minimum base is 50% of the total

research and development expense for the current taxable year. In the case of "basic research" the credit is 12 percent. For start-up companies with fewer than three taxable years, a fixed-base method is used—research expenditures qualify for the credit to the extent that they exceed 3% of a firm's California gross receipts. The credit is currently scheduled to sunset at the end of 1997.

Except for start-ups, California does not conform to the federal base period computation. Federal law provides that research expenditures in excess of a fixed base amount qualify for the credit. The base amount is determined by (1) calculating the ratio of research expenditures to gross receipts for a firm's 1984 through 1988 income years (the "fixed base percentage"); and (2) multiplying that ratio by the firm's average gross receipts during the past four years.

THIS BILL deletes the current 1997 sunset for the research and development credit, and substitutes the federal fixed base period for the present "rolling" three-year average base period. The bill also conforms with the new federal definition of start-up companies as.

This provision is part of the Assembly Democratic Economic Prosperity Team (Adept) package of business incentives. It is intended to be part of a coordinated attempt to stimulate more California economic development and make it possible for California to compete more effectively with other states in retaining and attracting business. This part of the package is "aimed at making capital more available for California's economic development.

Consultants: Martin Helmke & Anne Maitland
Revised 9-17-93

Appendix M

CHAPTER 601 1990 REG. SESSION
SEC. 2

SEC. 2. Subject to the provisions of Section 25111 of the Revenue and Taxation Code and Chapter 22 (commencing with Section 26071) of Part 11 of Division 2 of the Revenue and Taxation Code, in the event of a final appellate level determination by a California or federal court that the application of the worldwide combined report method or the requirement that amounts be paid pursuant to Section 25115 of the Revenue and Taxation Code is unconstitutional, amounts paid pursuant to Section 25115 of the Revenue and Taxation Code for income years beginning on or after January 1, 1988, shall, to the extent ordered by the court or as otherwise provided in Article 1.5 (commencing with Section 25110) of Chapter 17 of Part 11 of Division 2 of the Revenue and Taxation Code and regulations thereunder as of the effective date of this act, be refunded, with interest as provided in Section 26080 of the Revenue and Taxation Code, from funds in the California Unitary Fund, which is hereby appropriated to the Franchise Tax Board for that purpose.

In the event that there are insufficient funds in the California Unitary Fund for those refunds, refunds of amounts paid pursuant to Section 25115 of the Revenue and Taxation Code shall be paid from the General Fund. There is hereby appropriated from the General Fund to the Franchise Tax Board an amount necessary to pay the balance of those refunds.

Appendix N

13 May 1993

UNITARY TAXATION

The Chancellor of the Exchequer, the Rt. Hon Norman Lamont MP, today announced that the Government will have to take retaliatory measures in relation to United States based companies if there is not a satisfactory resolution of the unitary tax problem by the end of the year.

In reply to a Parliamentary Question, the Chancellor said:

> "US Treasury Secretary Bentsen has explained the US Administration's position. He and his colleagues recognise the importance the British Government attaches to this issue, the strength of feeling in the UK and the risk of retaliatory action by the UK if a satisfactory solution is not forthcoming. He has assured me that the Administration are very keen to find a solution to this problem that is acceptable. I have said that the Government is ready to discuss how an acceptable solution could best be achieved. But I have informed him that the Government will have to take retaliatory measures in relation to United States based companies if there is not a satisfactory resolution of the problem of the internationally-opposed unitary tax on foreign-owned companies in California by the end of this year. Meanwhile, I have instructed the Inland Revenue to obtain information from California-based companies in the UK, on the probable impact of such retaliatory measures."

Appendix O

Translation BMF—AG St—SH Bonn, June 1993

Resolution of the Finance Committee of the German Bundestag concerning unitary taxation in the State of California

The Finance Committee of the German Bundestag has today discussed the problem of unitary taxation as applied in the State of California to the cross-border apportionment of profits between associated enterprises.

The Finance Committee notes that this method of taxation used by the State of California is based on a flat-rate allocation of profits that is inconsistent with the internationally accepted arm's-length principle, that such allocation of profits can result in substantial double taxation and that it imposes disproportionate burdens on enterprises in discharging their tax filing obligations. In the opinion of the Committee, a "water's-edge" rule under which enterprises operating on an international basis can gain exemption from worldwide unitary taxation of their income only on payment of a large fee is also in conflict with the principles of taxation as agreed in the German-American Convention for the Avoidance of Double Taxation.

The Finance Committee notes with regret the departure of the new U.S. administration from the course followed by former U.S. administrations for more than 20 years. The rejection of unitary taxation has always been and still is both a reflection of mutually agreed positions and a necessary means of ensuring, among other things, that economic relations between the United States of America and the Federal Republic of Germany continue to function smoothly and without disruption.

The Finance Committee calls upon the new U.S. administration to return to the common approach adopted by all other OECD countries and to urge the State of California to relinquish, in the interest of avoiding disruptions of international trade, the system of unitary taxation that is rejected by all other industrialised nations.

The Finance Committee requests the German government to take immediate steps to consider the application of retaliatory mea-

sures should it prove impossible to achieve a satisfactory solution to the problem of unitary taxation within a reasonable period of time. In making this request, the Finance Committee proceeds on the assumption that it will be possible to reach a statisfactory [sic] solution by the end of 1993.

Appendix P

15 September 1993

UNITARY TAXATION

Commenting today on the news that the California State Legislature has reformed its unitary tax laws, the Chancellor of the Exchequer, The Rt. Hon. Kenneth Clarke QC MP, said:

> "I am greatly encouraged to learn that California has passed legislation to modify its unitary tax law. This development is a vindication of the Government's decision to set a definite time limit for the implementation of retaliatory measures. But for the Government's action it is clear that there would have been no progress in California. The approach that California has now adopted has been designed to bring to an end the problem of unitary tax for UK owned companies in California. However, given the defects that remain in the law, it will be important to ensure that the spirit of the new approach is followed in the detailed regulations and in the practical application of the law. The UK will therefore defer retaliatory action and will retaliate only if it is found that the legislation is being applied in a way which exposes UK owned companies to damage from taxation that is inconsistent with the arm's length principle. I am informing Secretary Bentsen accordingly.
>
> While the legislation in California is a significant step forward, on its own it does not provide a complete solution to the unitary tax problem. For a complete solution it will be necessary to have the internationally accepted arm's length principle endorsed, on a permanent basis, as the only valid method of taxing foreign companies in any State. Success for the Barclays case in the Supreme Court would achieve this. The Government will continue strongly to support Barclays' case. I hope it will succeed. If it does not, the UK will have to retain its retaliatory powers in reserve as a barrier against the possibility that States might damage UK owned companies by the imposition of unitary taxation at some time in the future."

Appendix Q

EMBASSY OF BELGIUM

3320 Garfield Street, N.W.
Washington, D.C. 20005

Washington, September 23, 1993

The Honorable
Warren Christopher
Secretary of State
Washington, D.C. 20520

Dear Mr. Secretary,

We have the honor to convey to you the attached note on unitary taxation on behalf of the Governments of the Member States of the European Community and the Commission of the European Communities.

We avail ourselves of this opportunity to renew to you the assurances of our highest consideration.

Juan Cassiers
Ambassador of Belgium
EC-Presidency

Andreas van Agt
Ambassador of the
Delegation of the Commission
of the European Communities

UNITARY TAXATION

1. The Member States of the European Community and the European Commission have the honour to refer to their note of 26 March 1993 in which they expressed their strong opposition to worldwide unitary taxation and urged the United States Government to support the Barclays petition for certiorari to the United States Supreme Court. The Member States, together with eight other major trading partners of the United States, subsequently supported the Barclays petition in an amicus curiae brief dated 22 April 1993.

2. The Member States and the European Commission note that the State of California has since passed legislation to modify its unitary tax law. While this legislation is an improvement, the Member States and the European Commission do not consider that the unitary tax problem is solved. Worldwide unitary taxation, which is contrary to the internationally agreed arm's length principle, is still the basis of the tax system in California. A complete solution will require the arm's length principle to be established as the only legitimate basis of taxing foreign companies in any state.

3. The Member States and the European Commission therefore continue strongly to urge the United States Government to support the Barclays petition for certiorari to the United States Supreme Court.

(15)

No. 92-1384

In the Supreme Court

OF THE

United States

October Term, 1993

Barclays Bank PLC
Petitioner,

vs.

Franchise Tax Board,
An Agency Of The State Of California
Respondent.

On Petition for a Writ of Certiorari to the Court of Appeal of the State of California in and for the Third Appellate District

SECOND SUPPLEMENTAL BRIEF OF PETITIONER

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6 P.P

SECOND SUPPLEMENTAL APPENDIX

Appendix R: Note of the Governments of the Member States of the European Communities (Belgium, Denmark, France, Federal Republic of Germany, Greece, Ireland, Italy, Luxembourg, the Netherlands, Portugal, Spain and United Kingdom) and the Governments of Australia, Austria, Canada, Finland, Japan, Norway, Sweden and Switzerland, October 14, 1993.

No. 92-1384

In the Supreme Court

OF THE

United States

OCTOBER TERM, 1993

BARCLAYS BANK PLC
Petitioner,

VS.

FRANCHISE TAX BOARD,
AN AGENCY OF THE STATE OF CALIFORNIA
Respondent.

On Petition for a Writ of Certiorari to the Court of Appeal of the State of California in and for the Third Appellate District

SECOND SUPPLEMENTAL BRIEF OF PETITIONER

Pursuant to Rule 15.7, Petitioner Barclays Bank PLC files this Second Supplemental Brief to its Petition for Writ of Certiorari to inform this Court of a Note to the United States Secretary of State sent on October 14, 1993, from the twelve Member States of the European Communities (Belgium, Denmark, France, Federal Republic of Germany, Greece, Ireland, Italy, Luxembourg, the Netherlands, Portugal, Spain and United Kingdom) and the governments of Australia, Austria, Canada, Finland, Japan, Norway, Sweden and Switzerland (the "twenty countries"). A copy of the Note is contained in this Second Supplemental Brief as Appendix R.

The Note is important because:

1. The Note is submitted by the twelve Member States of the European Communities, joined by the other eight nations, which, as a group, comprise the main trading partners of the United States and the majority of its trade.

2. The twenty countries do not consider the California legislation as a resolution of the problem of worldwide combined reporting.

3. The twenty countries confirm their consistent position that worldwide unitary taxation is contrary to the internationally agreed arm's length principle embodied in the bilateral treaties of the United States and disruptive of international economic relations.

4. The twenty countries view a complete solution to the problem as requiring the establishment of the arm's length principle as the only legitimate basis to tax foreign companies in any state.

For all these reasons, this Note contradicts the suggestion by the United States in its amicus curiae brief that "an accommodation of state, national and international interests . . . has been reached in this issue" or that the voluntary action of a single state solves the problem. Am. U.S. Br. No. 92-1384 at 10.

Respectfully submitted,

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Appendix R

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Washington

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From The Ambassador

14 October 1993

The Honorable
Warren M Christopher
Secretary of State
Department of State
7th Floor
Main State Department Building
2201 C Street NW
Washington DC 20520

Dear Mr. Secretary,

With the agreement of the other countries concerned, I have been asked to convey to you the attached note on unitary taxation on behalf of the governments of the member states of the European Community, and of Austria, Australia, Canada, Finland, Japan, Norway, Sweden and Switzerland.

Yours sincerely,

Robin Renwick

MESSAGE FROM THE SECRETARY OF STATE FOR FOREIGN AND COMMONWEALTH AFFAIRS TO THE HONORABLE WARREN CHRISTOPHER THURSDAY, 14 OCTOBER 1993

UNITARY TAXATION

The 12 Member States of the European Communities: Belgium, Denmark, France, Federal Republic of Germany, Greece, Ireland, Italy, Luxembourg, the Netherlands, Portugal, Spain and United Kingdom; and the governments of Australia, Austria, Canada, Finland, Japan, Norway, Sweden and Switzerland ("the 20 countries") have the honour to refer to their brief for the Supreme Court of the United States in the case of Barclays Bank plc v. Franchise Tax Board, dated 22 April 1993.

The countries concerned note that, since that date, the State of California has passed legislation to modify its unitary tax law. While this legislation is an improvement, the countries concerned do not consider that the unitary tax problem is finally resolved. Worldwide unitary taxation is contrary to the internationally agreed arm's length principle embodied in the bilateral tax treaties of the United States and disruptive of international economic relations. A complete solution would require the arm's length principle to be established as the only legitimate basis of taxing foreign companies in any state.

The 20 countries regret therefore that, in his brief filed on 7 October 1993, the Solicitor General of the United States does not support the Barclays petition for a writ of *certiorari*.

No. 92-1384

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Respondent.

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BRIEF OF THE GOVERNMENT OF THE UNITED KINGDOM AS AMICUS CURIAE SUPPORTING PETITIONER

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WILSON - EPES PRINTING CO., INC. - 789-0096 - WASHINGTON, D.C. 20001

QUESTION PRESENTED

The question this appeal presents is the constitutionality, under the Foreign Commerce Clause and the Due Process Clause of the United States Constitution, of California's application of the unconventional corporate income apportionment formula known as worldwide combined reporting to domestic corporations with foreign parents, or foreign corporations with foreign parents or foreign subsidiaries.

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BRIEF OF THE GOVERNMENT OF THE UNITED KINGDOM AS AMICUS CURIAE SUPPORTING PETITIONER

INTEREST OF THE UNITED KINGDOM

The Government of the United Kingdom ("United Kingdom") is specifically concerned that this petition for a writ of certiorari be granted because Petitioner is a member of but one of the many United Kingdom based corporate groups that continue to be adversely affected by Respondent's insistence upon the use of the corporate income allocation formula known as worldwide combined reporting ("WWCR"). Another United Kingdom cor-

poration, Imperial Chemical Industries, PLC, was recently before this Court when the Respondent appealed the decision of the United States Court of Appeals for the Seventh Circuit that foreign parent corporations had standing to contest Respondent's application of WWCR to them and their U.S. subsidiaries.[1]

The United Kingdom, the United States and all of their major trading partners, have long subscribed to an internationally accepted standard including the globally accepted arm's length separate accounting ("AL/SA") standard for allocating profits of multinational corporations between nations. WWCR contradicts that internationally accepted standard. The United Kingdom is generally concerned the issue be finally resolved because Respondent's use of WWCR, in contradiction to the established international tax standard, continues to harm trading and investment relations between the United States and the United Kingdom.

The United Kingdom and the United States have traditionally cooperated to discuss and resolve matters of mutual concern generally, and tax matters specifically. The United Kingdom is also interested that this Court hear Petitioner's appeal because the effectiveness of future negotiations with the United States Federal Government is doubtful if U.S. policy is going to be finally determined by state courts' interpretations of Federal Government policy.

The United Kingdom hereby submits this brief *amicus curiae* in support of Petitioner.[2]

---

[1] *Franchise Tax Board of California v. Alcan Aluminum, Ltd.*, 493 U.S. 331 (1990).

[2] Petitioner is successor in interest to Barclays Bank International, Limited and has assumed the interest of Barclays Bank of California for present tax matters and claims for refund.

Petitioner and Respondent have consented to the filing of this brief *amicus curiae* in letters filed with the Clerk of this Court.

STATEMENT

Ten years ago, this Court specifically reserved determination of the issue presented by this appeal, the constitutionality of Respondent Franchise Tax Board's application of WWCR to a domestic corporation with a United Kingdom parent (Barclays Bank of California ["BARCAL"], and a United Kingdom corporation with a United Kingdom parent and foreign subsidiaries (Barclays Bank International, Limited ["BBI]).[3] The United States Federal Government, all of the trading partners of the United States, and forty-seven of the United States have chosen AL/SA in apportioning income where corporate groups operate across national borders. Thus, this appeal does not involve a simple choice between two conflicting methods of income apportionment for foreign based multinational corporate groups. A determination is required as to whether Respondent may continue to apply WWCR to subject to California's taxing jurisdiction corporations operating outside the borders of the United States, in contradiction to the established policy of the United States Federal Government and the international community.

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[3] *Container Corp. of America v. Franchise Tax Bd.*, 463 U.S. 159 (1983).

ARGUMENT

I. WORLDWIDE COMBINED REPORTING CONFLICTS WITH INTERNATIONAL TAX POLICY.

The United Kingdom, the United States, and their trading partners all avoid double taxation of their corporate citizens through the use of AL/SA. The requirement for AL/SA has been contained in every tax treaty to which the United Kingdom, the United States, and their trading partners in the western world, have been, or are now, a party.[4] Under AL/SA, corporations are subject to tax solely by the jurisdiction in which they operate and only on that portion of their income attributable to the business carried on in that jurisdiction. Profits are subsequently taxable when distributed as dividends in those jurisdictions where the dividends are received for tax purposes.

Under AL/SA, the income of each member of a corporate group is computed by separate accounting on the basis that each member of the group must deal with other members as if they were wholly separate entities owned by unrelated interests. Profitable corporations are subject to tax where the profits are made, and the less profitable or unprofitable subsidiaries pay less or no tax in the jurisdictions where they conduct business.

Using WWCR, Respondent rejects the international corporate taxation principles of AL/SA, treats separate corporations—foreign and domestic—that are part of a multicorporate group as one, and subjects all the worldwide income of the international corporate group to tax as one "unitary" corporation. It apportions the group's combined income between California and the rest of the world on the basis of an arbitrary formula composed of

[4] For example: 1975 Income Tax Convention with the United Kingdom of Great Britain, and Northern Ireland, December 31, 1975, T.I.A.S. No. 9682.

the ratio of payroll, sales, and property of the combined corporate group in California compared to the world. Moreover, the income is combined without regard to whether such income is taxable under the Internal Revenue Code or applicable treaty or has been attributed to and taxed in foreign jurisdictions, under long-standing and well-recognized procedures established in international law. No nation and no other nation's local political subdivisions use WWCR. Forty-seven of the United States do not use WWCR.[5]

II. THE LOWER COURT DECISION PUTS IN DOUBT THE ABILITY OF THE UNITED STATES FEDERAL GOVERNMENT TO SPEAK FOR THE NATION IN INTERNATIONAL TAX MATTERS.

When Respondent combines through WWCR the income of BARCAL, BBI, and all their international affiliates, there can be no doubt income already subject to tax in the country of domicile is also being taxed by California. When California reaches through WWCR income taxable by the domiciliary foreign country, it forces two equally untenable choices upon that country: (1) allow its corporations to be doubly taxed; or (2) give a credit for the tax paid under WWCR, thereby suffering a loss in its own tax revenues.

The extraterritorial grasp of WWCR contradicts the very foundation of the customs of nations in international taxation. The double taxation resulting from its use adversely affects foreign countries, their corporations and their subsidiaries. Because WWCR is not used by any country, there can be no international system to reconcile or mitigate its adverse consequences.

[5] Only California and North Dakota apply WWCR to both domestic and foreign based multicorporate groups. Montana applies WWCR only to domestic based multicorporate groups.

As this Court made clear in *Japan Lines, Ltd. v. County of Los Angeles*:

> California, by its unilateral act, cannot be permitted to place these impediments before the Nation's conduct of its foreign relations and its foreign trade.[6]

This Court has also recognized that California is in no position to negotiate with the United Kingdom or other foreign governments, and neither tax treaties nor federal law provide a mechanism by which the United States Federal Government can negotiate double taxation arising out of state tax systems.[7]

The United Kingdom, and other trading partners of the United States, must rely on the power and authority of the United States Federal Government to speak for the nation with one voice. The lower court decision would establish the principle that unless and until the United States Congress acts to specifically limit a taxing state, it is free to tax as it pleases, even if that taxation is imposed upon foreign commerce. The United Kingdom and the United States cannot continue their efforts to harmonize international tax policies and manage the difficult problems of double taxation under such principle.

III. ALL THE ELEMENTS THIS COURT HAS PREVIOUSLY DETERMINED AS NECESSARY TO FINALLY DETERMINE THE CONSTITUTIONALITY OF RESPONDENT'S APPLICATION OF WORLDWIDE COMBINED REPORTING TO DOMESTIC CORPORATIONS WITH FOREIGN PARENTS, AND FOREIGN CORPORATIONS WITH EITHER FOREIGN PARENTS OR FOREIGN SUBSIDIARIES, ARE PRESENT HERE.

Container involved Respondent's application of WWCR to a domestic parent corporation with overseas subsidiaries. In that decision, this Court specifically reserved

[6] 441 U.S. 434, 453 (1979).

[7] *Container Corp., supra* at 193.

determination of the constitutionality of WWCR when applied to domestic corporations with foreign parents, or foreign corporations with either foreign parents or foreign subsidiaries.[8] The issue was left unresolved because the application of WWCR to foreign based multicorporate groups presents additional considerations deserving extensive constitutional scrutiny.[9]

This case, as opposed to *Container*, involves a domestic corporation with a foreign parent, and a foreign parent with a foreign parent and subsidiaries. Here, there is: (1) an "automatic asymmetry" between Respondent's use of WWCR and the acknowledged international tax structure; (2) the tax is imposed on a foreign entity and its subsidiary; and (3) it is a matter of international concern because the United Kingdom and other countries are interested in ensuring equitable taxation of their corporations.

The serious threat to the foreign policy of the United States posed by Respondent's use of WWCR is supported by factors that also were not present in *Container*. There can be no doubt that WWCR threatens the United States' foreign policy and that the taxation policy of the United States for domestic corporations with foreign parents, or foreign corporations with either foreign parents or foreign subsidiaries, is AL/SA, not WWCR. The Solicitor General has filed *amicus curiae* briefs at every court level in support of BARCAL and BBI.[10] Also present here is

[8] *Container Corp., supra* at 188 n.26, 196 n.32.

[9] *Japan Line, Ltd., supra* at 445-446; *Container Corp., supra* at 185; *Wardair Canada, Inc. v. Florida Dep't of Revenue*, 477 U.S. 1, at p. 8 (1986); *Kraft Gen. Foods, Inc. v. Iowa Dep't of Rev. and Finance*, —— U.S. ——, 112 S. Ct. 2365 (1992).

[10] Also see: November 8, 1985 Statement of President Ronald Reagan, 45 *Weekly Compilation of Presidential Documents* 1368; January 30, 1986 Letter from United States Secretary of State George P. Shultz to the Governor of California; and March 5, 1986 Letter of United States Secretary of the Treasury James A. Baker

proof of the most obvious foreign policy implication a state tax can have, to offend the United States' trading partners and lead them to retaliate.[11]

All of the United States' major trading partners have repeatedly expressed their offense at Respondent's application of WWCR to their corporate citizens.[12] The United Kingdom, after patiently awaiting the cessation of that use for over a decade, has enacted retaliatory legislation. Section 54 of and Schedule 13 to the Finance Act of 1985 (now reenacted as Section 812-815 of the Income and Corporations Taxes Act 1988) gives the United Kingdom the authority to deprive American parent corporations, with a presence in states that use WWCR, of the shareholders' tax credit the United Kingdom gives on dividends paid by their subsidiaries in the United Kingdom.[13] As Stephen Dorrell, Financial Secretary to the United Kingdom Treasury, told the House of Commons on May 14, 1992, the retaliatory legislation is "not a mere ornament on the statute book." [14]

CONCLUSION

The United Kingdom has long awaited determination of the question presented by this appeal. Since this Court reserved determination of that issue in *Container*, United Kingdom corporate citizens have continued to be adversely affected by California's persistent use of WWCR. In the interim, they have been wending their way through the state and Federal courts. The United Kingdom, the United States, and their mutual trading partners have filed *amicus curiae* briefs pointing out to each court along the way, *inter alia*, how WWCR disrupts international tax policy and prevents the United States from speaking with one voice in this area of international concern.

III to Representative Daniel Rostenkowski, Chairman of the House of Representatives Committee on Ways and Means.

[11] *Container Corp., supra* at 194.

[12] See for example: Brief of the Member States of the European Communities and the Governments of Australia, Austria, Canada, Finland, Japan, Norway, Sweden and Switzerland as *amici curiae* supporting Petitioner filed herein.

[13] House of Commons Official Report, *Parliamentary Debates* (Hansard), 1036 (9 July 1985) (statement of John Moore).

[14] House of Commons Official Report, *Parliamentary Debates* (Hansard), 810 (14 May 1992).

This Court left the issue unresolved in *Container* because it recognized that the application of WWCR to foreign based multicorporate groups presents considerations not displayed by domestic multicorporate groups. All of those considerations will be before the Court in this appeal.

The United Kingdom is anxious to have the issue resolved, before more harm is done to United Kingdom corporations and to United Kingdom-United States relations, and the ability of the two countries to resolve matters of international concern as sovereign nations is further weakened.

Petitioner's petition for a Writ of Certiorari should be granted.

Respectfully submitted,

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Dated: April 22, 1993

No. 92-1384

IN THE
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BRIEF OF THE MEMBER STATES OF THE EUROPEAN COMMUNITIES AND THE GOVERNMENTS OF AUSTRALIA, AUSTRIA, CANADA, FINLAND, JAPAN, NORWAY, SWEDEN AND SWITZERLAND AS AMICI CURIAE SUPPORTING PETITIONER

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BRIEF OF THE MEMBER STATES OF THE EUROPEAN COMMUNITIES AND THE GOVERNMENTS OF AUSTRALIA, AUSTRIA, CANADA, FINLAND, JAPAN, NORWAY, SWEDEN AND SWITZERLAND AS AMICI CURIAE SUPPORTING PETITIONER

INTEREST OF AMICI CURIAE

The twelve Member States of the European Communities: Belgium, Denmark, France, Federal Republic of Germany, Greece, Ireland, Italy, Luxembourg, The Netherlands, Portugal, Spain, and the United Kingdom; and the Governments of Australia, Austria, Canada, Finland, Japan, Norway, Sweden and Switzerland (herein "the

Twenty Countries") are the United States' main trading partners, accounting for the majority of U.S. trade. Nineteen of the Twenty Countries have a double taxation and/or friendship, commerce and navigation treaty in force with the United States, the effect of which is to forbid the use of the method of corporate income allocation known as worldwide combined reporting ("WWCR").[1]

The issue presented by Petitioner's petition for a writ of ceritorari is the constitutionality of the application of WWCR by the Respondent Franchise Tax Board of the State of California to domestic corporations with foreign parents, or foreign corporations with either foreign parents or foreign subsidiaries. This Court reserved resolution of that issue when it considered the constitutionality of Respondent's use of WWCR to tax the income of U.S. based multicorporate groups.[2]

Determination of the constitutionality of the application of WWCR to domestic corporations with foreign parents, or foreign corporations with either foreign parents or foreign subsidiaries, is of significant importance to the Twenty Countries. The decision will impact their future economic and commercial relations with the United States and influence future bilateral treaty negotiations.

The Twenty Countries submit this brief *amicus curiae* in support of Petitioner.[3]

[1] Portugal and the United States are currently involved in bilateral tax treaty negotiations.

[2] *Container Corp. of America v. Franchise Tax Board*, 463 U.S. 159, 189 n.26 (1983).

[3] Petitioner and Respondent have consented to the filing of this brief *amicus curiae* in letters filed with the Clerk of this Court.

ARGUMENT

Corporate citizens of the Twenty Countries are adversely affected by Respondent's use of WWCR. Respondent claims it is taxing only one corporation's operations in California. However, it includes in a taxed corporation's tax base and apportionment formula that corporation's income and property, payroll and sales factors, and the income and factors of the worldwide operations of all foreign corporations considered to be conducting a unitary business with it, with no provision for crediting the taxes already assessed upon such income in the foreign jurisdiction where it was earned.

The Twenty Countries have repeatedly expressed their formal objections to Respondent's use of WWCR as:

(1) contradictory to, and incompatible with, accepted international principles of corporate tax assessment and the purpose of double taxation and/or friendship, commerce and navigation treaties to which the United States is a party;

(2) an impediment to investment and trade with the U.S.[4]

[4] Protocol to the Convention with France on Income Taxes, signed Nov. 24, 1979, 2 Tax Treaties, (CCH) 2819-23T; Demarche from Italy, President European Communities, on behalf of the Member States of the European Communities, March 13, 1980; Demarche No. 51 from the United Kingdom Embassy, March 25, 1980; Demarche No. 211 from the United Kingdom, President European Communities, on behalf of the Member States of the European Communities, October 30, 1981; Demarche No. 83 from the United Kingdom Embassy, May 18, 1982; Demarche from Belgium, President European Communities, on behalf of the Member States of the European Communities, June 29, 1982; Demarche from Greece, President European Communities, on behalf of the Member States of the European Communities, August 1, 1983; Aide-Memoire from Government of Japan, August 11, 1983; Demarche from Greece, President European Communities, on behalf of the Member States of the European Communities, September 23, 1983; Demarche No. 383/83 from Embassy of Australia, November 7, 1983; Demarche No. 461.20-LJ/hu from Embassy of Switzerland, November

The Twenty Countries have also conveyed their objections to WWCR to state and Federal courts by filing *amicus curiae* briefs. This *amicus curiae* brief and the March 6, 1993 demarche from Denmark, President European Communities, on behalf of the Member States of the European Communities, the text of which is contained in the appendix to this brief, are the latest demonstrations of the Twenty Countries' objections to Respondent's use of WWCR.

The Twenty Countries are anxious to have the question of the constitutionality of the Respondent's application of WWCR to domestic corporations with foreign parents, or foreign corporations with either foreign parents or foreign subsidiaries, resolved before more harm is done to their relations with the United States and to prevent the continued double taxation of their corporate citizens.

15, 1983; Demarche from the Republic of Germany, November 28, 1983; Demarche EA-14533 from Embassy of the Netherlands, December 21, 1983; Demarche from Belgium, President European Communities, supported by the Member States of the European Communities, the European Commission, and the Embassies of Australia, Japan, Canada, and Switzerland, January 1, 1984; Demarche from Embassy of Belgium, January 25, 1984; Aide-Memoire from Government of Japan, June 6, 1984; Demarche from Ireland, President European Communities, on behalf of the Member States of the European Communities, December 20, 1984; Demarche from the Commission of the European Communities and the Embassy of Luxembourg, August 8, 1985; Demarche from Member States of the European Communities and the Commission of the European Communities, August 30, 1985; Letter from Ambassador of Spain on behalf of Member States of the European Communities to U.S. Secretary of State, James A. Baker III, June 30, 1989; Demarche from the United Kingdom, President European Communities, on behalf of the Member States of the European Communities, July 22, 1992.

CONCLUSION

The twelve Member States of the European Communities: Belgium, Denmark, France, Federal Republic of Germany, Greece, Ireland, Italy, Luxembourg, The Netherlands, Portugal, Spain, and the United Kingdom; and the Governments of Australia, Austria, Canada, Finland, Japan, Norway, Sweden and Switzerland ask that Petitioner's petition for a writ of certiorari be granted.

Respectfully submitted,

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Dated: April 22, 1993

APPENDIX

APPENDIX

ROYAL DUTCH EMBASSY
Washington, D.C.

The Honorable
Warren Christopher
Secretary of State
Washington, D.C. 20020

Copy (copies) 1 Enclosure(s) Ref.: 30, USA, 6/1

Date 3, 26, 1993

Dear Mr. Secretary:

We have the honor to convey to you the attached note on unitary taxation on behalf of the Governments of the Member States of the European Community and the Commission of the European Communities.

We avail ourselves of this opportunity to renew to you the assurances of our highest consideration.

/s/ Peter P. Dyvig
PETER P. DYVIG
Ambassador of Denmark
EC-Presidency

/s/ Andreas van Agt
ANDREAS VAN AGT
Ambassador of the
Delegation of the Commission
of the European Communities

UNITARY TAXATION

1. The Member States of the European Community and the European Commission note with dismay that the California Supreme Court recently denied the petition for review of the finding of the California Court of Appeal in the case of *Barclays Bank v. California Franchise Tax Board* which, together with the earlier decision of the California Supreme Court, held that the worldwide combined reporting imposed on foreign multinational corporations by the State of California is constitutional.

2. The worldwide combined reporting method of taxation is contrary to the internationally accepted arm's length taxation method which underlies the double taxation treaties and friendship, commerce and navigation treaties constituting the framework for international cooperation among the Member States and the United States.

3. The views of the EC Member States on worldwide unitary taxation are well known to the United States Government. All Member States have expressed their strong opposition to this tax in a number of diplomatic communiques to the United States Government from 1980 to the present date. Most recently the Member States expressed opposition in an amicus curiae brief filed with the United States Supreme Court. All of the criticisms expressed previously are germane today. Our Member States remain firmly convinced that the unitary basis of taxation is entirely unsatisfactory. We look to the United States Government to address the issue urgently.

4. The EC Member States and the European Commission support Barclays Bank in its opposition to California's application of the unitary basis of taxation. We strongly urge the United States Government to support the Barclays petition for certiorari to the United States Supreme Court and to continue its amicus curiae support.

Washington, D.C.
March 26, 1993

No. 92-1384

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PETITION FOR A WRIT OF CERTIORARI TO THE COURT OF APPEAL OF THE STATE OF CALIFORNIA IN AND FOR THE THIRD APPELLATE DISTRICT

BRIEF *AMICUS CURIAE* ON BEHALF OF REUTERS LIMITED IN SUPPORT OF PETITIONER BARCLAYS BANK PLC

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BRIEF *AMICUS CURIAE* ON BEHALF OF REUTERS LIMITED IN SUPPORT OF PETITIONER BARCLAYS BANK PLC

INTEREST OF THE AMICUS CURIAE REUTERS

Reuters Limited, one of many subsidiaries of Reuters Holdings PLC, a United Kingdom company, supplies news and financial services worldwide. Reuters is currently a party to litigation with the New York State tax authorities challenging the constitutionality, under the Foreign Commerce Clause, of the very heavy compliance burden imposed upon Reuters by New York State's worldwide reporting requirements. That case is currently pending in the New York Court of Appeals, where

argument has been scheduled for September 8, 1993. *Reuters Limited* v. *Tax Appeals Tribunal*, 180 A.D. 2d 270, 584 N.Y.S. 2d 932 (3d Dept. 1992), *appeal granted*, Mo. No. 1285 (Feb. 11, 1993). Reuters submits this brief because the instant case presents the same issue under California law, and to underscore the importance of that issue to foreign multinational corporations that, as part of their worldwide operations, do business in the United States.

SUMMARY OF ARGUMENT

The imposition of a worldwide reporting requirement on multinational corporations by certain states has created a substantial burden on multinational corporations that do business in the United States as part of their worldwide operations. This burden directly conflicts with the international norm, which requires only that multinational corporations keep their books and records in accordance with *home country* requirements — not the requirements of other countries in which they happen to do business. It also runs afoul of decisions of this Court which recognize that discriminatory burdens on foreign commerce are subject to heightened scrutiny under the Foreign Commerce Clause. *See e.g., Kraft General Foods, Inc.* v. *Iowa Department of Revenue and Finance* ___ U.S. ___, 112 S.Ct. 2365 (1992); *Japan Line, Ltd.* v. *County of Los Angeles*, 441 U.S. 434 (1979).

ARGUMENT

Barclays does business in over forty non-U.S. jurisdictions. The trial court found that it would have cost over $5 million to establish a system which would allow compliance with the California requirements and over $2 million annually to maintain it. Reuters had business operations in over 80 countries in addition to the United States, and the uncontroverted evidence at trial was that the annual costs to comply with the record-keeping required by New York tax law would be considerably higher than the amount of tax claimed by the state for the years involved in the litigation. Costs of this magnitude must be given constitutional scrutiny. *Japan Line Ltd.* v. *County of Los Angeles*, 441 U.S. 434 (1979).

Of the 80+ non-domiciliary countries in which Reuters had operations during the years involved in its case, only New York required Reuters to recast Reuters[1] worldwide accounts in accordance with its own tax-accounting rules. Neither the U.S. federal government nor any foreign country other than Reuters home jurisdiction, the United Kingdom, imposed such a requirement upon Reuters.

It is the international norm that a multinational company must conform its worldwide accounts to the standards prevailing in its home country. It violates this norm for a non-home country — let alone a political subdivision of a non-home country — to impose such a requirement on a multinational corporation. Were the practice to become general, it is not clear that Reuters, Barclays, and other widespread multinational corporations could remain in business.

The need for guidance in this area has become urgent. If the states are to be free to erect a substantial administrative obstacle to foreign firms that wish to do business within their borders, that should be made clear promptly so that multinational corporations can plan their operations accordingly. Conversely, if the states are not to have complete freedom to impose this discriminatory burden, a decision to that effect will remove the obstacle for foreign firms that desire to invest in certain U.S. states, but refrain from doing so because of the prospect that they will be required to create and maintain one or more new, onerous worldwide reporting systems in addition to the one they must maintain to conform to their home country's requirements.

[1] As a matter of style, Reuters does not use the possesive form — Reuters' — even where convention would use that form.

CONCLUSION

For these reasons, Reuters supports Barclays petition for certiorari in this case.

Respectfully submitted,

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No. 92-1384

In the Supreme Court

OF THE

United States

OCTOBER TERM, 1992

BARCLAYS BANK PLC,
Petitioner,

vs.

FRANCHISE TAX BOARD,
An Agency of the State of California
Respondent.

Petition for a Writ of Certiorari to the Court of Appeal of the State of California In and For the Third Appellate District

BRIEF FOR NESTLÉ HOLDINGS, INC. AND MILES INC. AS AMICI CURIAE IN SUPPORT OF PETITION FOR WRIT OF CERTIORARI

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BRIEF FOR NESTLÉ HOLDINGS, INC. AND MILES INC. AS AMICI CURIAE IN SUPPORT OF PETITION FOR A WRIT OF CERTIORARI

INTEREST OF AMICI CURIAE

Amici curiae are corporations incorporated, commercially domiciled, and doing business in the United States. Each is owned entirely by a corporation incorporated in a foreign country. Each is presently engaged in a franchise tax controversy with the California Franchise Tax Board regarding the ability of the Franchise Tax Board to include the United States operations of amici and their United States subsidiaries in a single unitary business with the foreign operations of their foreign parents and affiliates. The foreign operations that are

the subject of these controversies are entirely conducted by corporations incorporated, commercially domiciled, and doing business in foreign countries. Amici therefore have a strong interest in the constitutional principles governing methods of state taxation which affect foreign coporations as well as the governmental relations between the United States and foreign governments. The California Supreme Court's decision would substantially alter those principles by treating congressional silence as consent to the Franchise Tax Board's worldwide unitary method of taxation. Such an alteration would significantly affect both the tax liabilities of amici and the environment in which they conduct their business. Specifically, allowing the California Supreme Court's decision to stand would affect the relationship between the government of the United States and the governments of Switzerland and Germany in which amici's parent corporations are based.

Counsel for the parties have consented to the filing of this brief in letters filed with the Clerk of the Court.

SUMMARY OF THE ARGUMENT

I. When Congress exercises its power under the Commerce Clause to consent to a state law, it eliminates any question of the validity of the law under the dormant Commerce Clause. This is so even though the law might burden interstate or foreign commerce in the absence of congressional consent. Recognizing the considerable consequences that emanate from a finding of congressional consent, this Court has consistently required that Congress manifest its consent to state law through unambiguous affirmative action. *See, e.g., Wyoming v. Oklahoma*, 112 S. Ct. 789, 802 (1992); *Maine v. Taylor*, 477 U.S. 131, 138-9 (1986); *South-Central Timber Development, Inc. v. Wunnicke*, 467 U.S. 82, 91-92 (1984); *Sporhase v. Nebraska ex rel. Douglas*, 458 U.S. 941, 960 (1982); *New England Power Co. v. New Hampshire*, 455 U.S. 331, 343 (1982).

Despite this well-established body of case law, the California Supreme Court found congressional consent to California's use of the worldwide combined reporting method of taxation not in unambiguous affirmative action, but rather

in "the din of a 'governmental silence'." Pet. App. C-26. The court justified its novel approach by relying almost exclusively on this Court's decision in *Wardair Canada Inc. v. Department of Revenue*, 477 U.S. 1 (1986). The state court found that *Wardair* represented "if not a change of course in the high court's dormant commerce clause jurisprudence, at least a retrenchment in its scope." Pet. App. C-24. The court's conclusion that congressional silence and inaction can form the ground of congressional consent, however, cannot be reconciled with *Wardair* or decisions of this Court prior to and following *Wardair*. Indeed, *Wardair* itself found consent on the ground that "the Federal Government has not remained silent" but rather "has affirmatively decided to permit" the state tax there at issue. *Wardair*, 477 U.S. at 12.

The California court's attack on this Court's criteria for determining congressional consent warrants review for three reasons. First, important policies of free trade protection surround this Court's insistence on clear expressions of congressional consent, and these policies will be jeopardized if review is not granted. Moreover, if the standard for determining congressional consent is to be so dramatically curtailed, it is the prerogative of this Court, not the California Supreme Court, so to rule. Second, the California Supreme Court's misreading of *Wardair* demands correction. *Wardair* does not represent a retrenchment in the scope of this Court's dormant Commerce Clause jurisprudence, but rather is fully consistent with this Court's earlier, and later, decisions. It is incumbent upon this Court to clarify any confusion surrounding the standards for congressional consent in order to prevent further misreading by other courts. Finally, and perhaps most importantly, if congressional silence alone can justify congressional consent, the scope of protection from burdensome state laws offered by the dormant Commerce Clause will be severely restricted, perhaps to the extent that such protection will become nonexistent. The implications of the decision below are therefore destructive of the free trade purpose underlying the Commerce Clause and should be repudiated by this Court.

II. The inaction of Congress in this case is inconsistent with any plausible view of consent and certainly does not establish the factual basis for consent found in *Wardair*. Whereas the Court in *Wardair* found consent in a series of international agreements that specifically considered the state taxation at issue, the California Supreme Court found consent by implication in a series of congressional inactions and failures to act. Four of the five items of inaction relied on by the California Supreme Court to find congressional consent do not even mention the question of states' use of worldwide combined reporting, expressing no more than a preference for separate accounting at the federal level. The single item which even addresses the taxing method at issue is the failure to obtain the necessary two-thirds votes to ratify a treaty containing a provision prohibiting states' use of worldwide combined reporting. However, a majority of Senators voted to support the provision, negating any possible inference of consent from the failure to act.

Finally, the five factors found by the California Supreme Court to constitute congressional consent all existed prior to this Court's decision in *Container Corporation of America v. Franchise Tax Board*, 463 U.S. 159 (1983). Nevertheless, despite the presence of these factors at that time, this Court engaged in dormant Commerce Clause analysis and therefore did not find that Congress had consented to worldwide combined reporting.

REASONS FOR GRANTING THE PETITION

This case presents issues of considerable importance to the foreign relations of the United States and to the Court's Foreign Commerce Clause jurisprudence. As detailed in Barclays' petition, and in the supporting briefs filed by other amici, California's worldwide combined reporting requirements, particularly as applied to multinational corporate affiliates with foreign parents, have been the focus of enormous international controversy. Moreover, the decision below sustaining California's taxing scheme disregards "sensitive matters of foreign relations and national sovereignty" recognized by the Court in *Japan Line, Ltd. v. County of Los Angeles*, 441

U.S. 434, 456 (1979). These considerations alone justify the grant of Barclays' petition.

There is, however, another compelling reason for reviewing the decision below: The California Supreme Court adopted an unwarranted approach to ascertaining whether Congress has consented to state law under the Commerce Clause (thus precluding an inquiry into the validity of the law under the dormant Commerce Clause). By discovering congressional consent in the "din of a 'governmental silence'" (Pet. App. C-26), the court below has made a mockery of the very concept of consent. Moreover, the court's analysis cannot be reconciled with this Court's precedents that consistently refuse to infer congressional approval of state action from congressional inaction. In urging the Court to grant Barclays' petition, amici Nestlé Holdings, Inc., et al. focus their attention on the critical question of Commerce Clause jurisprudence raised by the California Supreme Court's disposition of the congressional consent issue.

I. THE CALIFORNIA SUPREME COURT'S VIEW THAT CONGRESS' SILENCE CONSTITUTES CONSENT UNDER THE COMMERCE CLAUSE IS INCOMPATIBLE WITH THIS COURT'S PRECEDENTS AND THE FREE TRADE PURPOSES UNDERLYING THE COMMERCE CLAUSE

A. In Recognizing Congress' Power to Consent to State Laws That Would Otherwise Be Unconstitutional Under the Dormant Commerce Clause, This Court Has Equated Consent With Affirmative Congressional Action

The appropriate standard for determining when Congress has consented to state law under the Commerce Clause is grounded in the underlying principle that accords congressional consent its crucial constitutional function in this domain. The principle was first articulated a century ago in *In re Rahrer*, 140 U.S. 545 (1891), and given its definitive modern exposition in *Prudential Ins. Co. v. Benjamin*, 328 U.S. 408 (1946).

In *Prudential*, the Court considered a challenge under the negative implications of the Commerce Clause to a South Carolina tax on insurance companies that allegedly discriminated against interstate commerce. Congress had provided in the McCarran Act, however, that "taxation by the several States of the business of insurance is in the public interest, and that silence on the part of the Congress shall not be construed to impose any barrier to the... taxation of such business...." 15 U.S.C. § 1011. In addressing the question whether its dormant Commerce Clause cases had any bearing on the taxpayer's claim, the Court first observed that "[t]hose cases... presented no question of the validity of such a tax where Congress had taken *affirmative action* consenting to it...." 328 U.S. at 421 (emphasis supplied).

Because the taxpayer argued that the Commerce Clause, by its own force, nevertheless limited "Congress' permissible *action* in this respect" (*id*. at 422 (emphasis supplied)), the Court proceeded to address the merits of the question. The Court put the question this way: "[I]f the commerce clause, 'by its own force' forbids discriminatory state taxation, or other measures, how is it that Congress *by expressly consenting* can give that action validity?" *Id.* at 426 (emphasis supplied). The answer was easy. When Congress has *acted* under its commerce power, whether to preempt or consent to state laws, any question of the validity of the state law under the dormant Commerce Clause simply disappears. Indeed, "whenever Congress' judgment has been *uttered affirmatively* to contradict the Court's previously expressed view that specific action taken by the states in Congress' silence was forbidden by the commerce clause, this body has accommodated its previous judgment to Congress' *expressed approval*." *Id.* at 425 (emphasis supplied). Since Congress had "*expressly stated* its intent and policy" (*id.* at 427 (emphasis supplied)) regarding the states' freedom to tax the insurance industry in the McCarran Act, the Court was "not required to determine whether South Carolina's tax would be valid in the dormancy of Congress' power." *Id*.

The requirement that Congress' consent to state laws under the Commerce Clause be reflected in Congress' affirmative action is necessitated by the profound consequences of finding such consent. As the Court noted in *Prudential*, because Congress has plenary power over the channels of interstate commerce, "Congress may keep the way open, confine it broadly or closely, or close it entirely" (*id.* at 434), subject only to the limitations that the Constitution imposes on Congress' own power. This includes, of course, the power to authorize state laws that discriminate against or otherwise burden interstate commerce, laws that would be struck down in the absence of congressional action consenting to them. *Id*. By clearly indicating that congressional consent was a function of affirmative action by Congress, the Court in *Prudential* protected the values underlying the dormant Commerce Clause from erosion through findings of implied congressional consent while recognizing Congress' plenary power to expand or contract state tax power without regard to the restraints imposed by the dormant Commerce Clause.

B. This Court's Precedents Uniformly Require That Congress Manifest Its Consent to State Laws Under the Commerce Clause by Unambiguous Affirmative Action

Because Congress' consent to state laws under the Commerce Clause completely removes them from judicial scrutiny under the negative Commerce Clause, the Court, faithful to the teachings of *Prudential*, has properly insisted that Congress manifest its consent to state law through unambiguous affirmative action. Thus the Court has repeatedly stressed that "an unambiguous indication of congressional intent is required before a federal statute will be read to authorize otherwise invalid state legislation" and provide an "exemption from Commerce Clause scrutiny." *Maine v. Taylor*, 477 U.S. 131, 138-39 (1986); *see also Wyoming v. Oklahoma*, 112 S. Ct. 789, 802 (1992) ("Congress must manifest its unambiguous intent before a federal statute will be read to permit or approve... a violation of the Commerce Clause"); *South-Central Timber Development, Inc. v. Wunnicke*, 467 U.S. 82, 91-92 (1984)

(rejecting "'implicit approval' theory" of congressional consent and reaffirming "a rule requiring a clear expression of approval by Congress"); *Sporhase v. Nebraska ex rel. Douglas*, 458 U.S. 941, 960 (1982) ("[i]n the instances in which we have found such [congressional] consent, Congress' '"intent and policy" to sustain state legislation from attack under the Commerce Clause' was '"expressly stated"'"); *New England Power Co. v. New Hampshire*, 455 U.S. 331, 343 (1982) ("when Congress has not 'expressly stated its intent and policy' to sustain state legislation from attack under the Commerce Clause,... we have no authority to rewrite its legislation based on mere speculation as to what Congress 'probably had in mind'").

Without such a rule of unambiguous congressional action as a predicate to finding that Congress has consented to state law under the Commerce Clause, the fundamental values that the Commerce Clause was designed to protect would be jeopardized. The Court has recognized that "[t]he very purpose of the Commerce Clause was to create an area of free trade among the several States." *McLeod v. J.E. Dilworth Co.*, 322 U.S. 327, 330 (1944). The Court has protected the core value of free trade within a national market in its numerous decisions under the dormant Commerce Clause striking down state laws that burden interstate commerce. To be sure, Congress is free to remove the protective shield of these decisions when it sees fit to do so. But to expose interstate or foreign commerce to burdensome state legislation without the clearest signal from Congress of its intent to strip such commerce of the protections it ordinarily enjoys would undermine our constitutional scheme. "Absent a 'clear expression of approval by Congress,' any relaxation in the restrictions on state power otherwise imposed by the Commerce Clause unacceptably increases 'the risk that unrepresented interests will be adversely affected by restraints on commerce.'" *Maine v. Taylor*, 477 U.S. at 139.

C. The California Supreme Court's Novel Approach to Ascertaining Congressional Consent to State Laws Under the Commerce Clause Cannot Be Reconciled With This Court's Decisions and Raises an Issue of Broad National Significance Warranting Review by This Court

Despite the large and settled body of case law bearing on congressional consent to state law under the Commerce Clause, the decision below virtually ignored it in holding that congressional consent could be found in "a species of governmental *silence* that forecloses resort to a dormant foreign commerce clause analysis." Pet. App. C-21 (emphasis in original). As a result, the court relied on a series of congressional inactions in finding that Congress had consented to California's requirement of worldwide combined reporting. *See* pp. 14–15, *infra*. Even if these congressional inactions were relevant to the question of consent under the Commerce Clause, we demonstrate below that they could not conceivably support the inference that Congress has, in fact, consented to California's taxing scheme. *See* pp. 15–20, *infra*. First, however, we consider the more fundamental error of the opinion below, namely, that congressional silence can lay the foundation for a finding of Congress' consent to state law under the Commerce Clause.

The California court's view that "the din of a 'governmental silence'" (Pet. App. C-26) provides a legitimate basis for discerning congressional consent to state law, thereby obviating an inquiry into the law's validity under the dormant Commerce Clause, rests entirely on its reading of *Wardair Canada Inc. v. Department of Revenue*, 477 U.S. 1 (1986). *Wardair* involved the imposition of a Florida sales tax on aviation fuel purchased in Florida by a foreign air carrier for use in international flights. The carrier challenged the tax on two theories: first, it was preempted by federal legislation; second, it was barred by the dormant Commerce Clause.

The Court rejected the preemption argument on the ground that Congress had expressly permitted the states to impose "sales or use taxes on the sale of goods or services" (Federal Aviation Act of 1958, § 1113(b), 15 U.S.C. § 1513),

which included airline fuel. 477 U.S. at 6-7. Such an affirmative statement by Congress might itself have been deemed sufficient to constitute consent to the state law, thereby precluding any further inquiry into the matter under the negative implications of the Commerce Clause. The Court nevertheless felt compelled to go further in responding to the taxpayer's dormant Commerce Clause argument because it felt Congress may not have expressly considered the imposition of such taxes on *foreign* air carriers in enacting section 1113 of the Federal Aviation Act, even though that section did not by its terms distinguish between foreign and domestic carriers. 477 U.S. at 7. Thus, consistent with its precedents addressing congressional consent to state law (*see* pp. 7–8, *supra*), the Court adopted an extremely high standard for finding express approval of a state tax, requiring a clear indication that Congress had intentionally taken legislative action manifesting consent to the tax.

The Court did not need to look far beyond the Federal Aviation Act, however, in order to find that Congress through unambiguous affirmative action had given its approval to the state tax in question. Thus the Court relied on a series of international agreements which "demonstrate that the Federal Government has *affirmatively acted*, rather than remained silent, with respect to the power of the States to tax aviation fuel." *Id*. at 9 (emphasis supplied). The "*actions* taken by the Federal Government [which] accept the authority of the States to tax as Florida has here" (*id.*) (emphasis supplied) included the Chicago Convention on International Aviation, which specifically addressed the question of state and local taxation of aviation fuel, and more than 70 bilateral agreements that "acquiesced in state taxation of fuel used by foreign carriers in international travel." *Id*. at 12.

What all this made "abundantly clear" (*id.*) to the Court was that "the Federal government *has not remained silent* with regard to the question whether the States should have the power to impose taxes on aviation fuel used by foreign carriers in international travel." *Id.* (emphasis supplied). Because the "Federal Government *has affirmatively decided* to permit the

States to impose these sales taxes on aviation fuel" (*id.*) (emphasis supplied), and because "it would turn dormant Commerce Clause analysis upside down to apply it where the *Federal Government has acted*" (*id.*) (emphasis supplied), the Court concluded that Congress had consented to the Florida tax and there was no need to consider its validity under the dormant Commerce Clause.

Despite the Court's unequivocal holding in *Wardair*, reflecting the lessons of its earlier decisions, that affirmative congressional action is the touchstone of congressional consent to state law under the Commerce Clause, the court below nevertheless found that Congress had consented to California's worldwide combined reporting scheme based on congressional silence and inaction. *See* pp. 14–20, *infra*. The court justified its departure from this Court's precedents on the ground that *Wardair* itself "represents, if not a change of course in the high court's dormant commerce clause jurisprudence, at least a retrenchment in its scope." Pet. App. C-26. According to the court below, *Wardair* "can be abstracted into a kind of protocol for identifying those kinds of governmental silences that give rise to 'negative implications' supporting an inference of federal acquiescence in the state tax under challenge." Pet. App. C-23. And it read *Wardair* as "establish[ing] an interpretive framework for educing from a compilation of legislative materials a species of governmental *silence* that forecloses resort to dormant commerce clause analysis." Pet. App. C-21 (emphasis in original).

The California Supreme Court's frontal assault on this Court's criteria for determining when Congress has consented to state law under the Commerce Clause plainly warrants the Court's plenary review. In the first place, there is no justification either in constitutional policy or in this Court's precedents for the extraordinary suggestion of the court below that Congress' silence constitutes consent under the Commerce Clause. As we have explained above, both the policy and law are to the contrary, and the California court has advanced no sound reason for abandoning it. In any event, it is clearly the prerogative of this Court — not a state court — to determine

whether its decisions should be overturned. *Rodriguez de Ouijas v. Shearson/American Express, Inc.*, 490 U.S. 477, 484 (1989).

Second, even if there are some suggestions in *Wardair* that the "negative implications" (477 U.S. at 10, 12) of affirmative congressional action can lay the evidentiary predicate for a finding of congressional consent to state law, these suggestions do not license a state court to base a finding of consent on the negative implications of congressional *inaction*, which is what the California court did here. *See* pp. 13–20, *infra*. The Court in *Wardair* explicitly declared that it was drawing negative inferences from governmental action — not governmental omission — in finding that Congress had affirmatively consented to the tax at issue.

Third, the suggestion that *Wardair* "represents, if not a change of course in the high court's dormant commerce clause jurisprudence, at least a retrenchment in its scope" (Pet. App. C-24) is unfounded. *Wardair* is woven from the same cloth as the Court's earlier decisions involving congressional consent (*see* pp. 7–8, *supra*), as well as from its later decisions. *Id*. Indeed, the claim that there has been a "retrenchment" in the Court's foreign Commerce Clause jurisprudence is belied by the Court's most recent decision in this domain. *Kraft General Foods, Inc. v. Iowa Department of Revenue and Finance*, 112 S. Ct. 2365 (1992). In any event, insofar as one might read *Wardair* as relaxing the standards for finding congressional consent to state law, *Wardair*, 477 U.S. at 18-20 (Blackmun, J., dissenting), it is incumbent upon this Court to clarify those standards so they will not be subject to the misreading that they received below.

Finally, the implications of the decision below are destructive of the free trade purposes underlying the Commerce Clause, which provides the basis for this Court's dormant Commerce Clause jurisprudence. For this reason as well, the decision below should not be left undisturbed. Under the California court's analysis, "silence" becomes a basis for inferring consent to state law under the Commerce Clause. Yet it is this very "silence" that has for two centuries been the basis for

the Court's dormant Commerce Clause jurisprudence. If congressional silence can justify a finding of congressional consent to state laws, then there may well be no room for the dormant Commerce Clause to operate at all. At a minimum, its scope may be substantially narrowed, and courts will have to distinguish between the kinds of "silence" that warrant a dormant Commerce Clause inquiry and those that preclude judicial scrutiny of the state law altogether. These questions are indisputably worthy of this Court's attention.

II. THE DECISION BELOW CANNOT BE RECONCILED WITH *WARDAIR* AND RENDERS THE CONCEPT OF CONGRESSIONAL CONSENT MEANINGLESS

The inaction of Congress in this case is inconsistent with any plausible view of consent and certainly does not establish the factual basis for consent found in *Wardair*. If left undisturbed, the California's court's opinion would leave the law in this area in shambles.

As noted above, in *Wardair*, this Court found it unnecessary to engage in dormant Commerce Clause analysis because it was "abundantly clear" that the federal government had *acted* rather than remained silent. *Wardair*, 477 U.S. at 12. The Court found this affirmative action in three sources: (1) the Chicago Convention on International Civil Aviation entered into by the United States on December 7, 1944; (2) a Resolution adopted November 14, 1966, by the International Civil Aviation Organization, of which the United States is a member; and (3) bilateral agreements concluded between the United States and various foreign countries.

The Chicago Convention specifically considered subnational taxation of aviation fuels and prohibited local taxes on fuel only when the fuel was "on board an aircraft... on arrival... and retained on board on leaving." Consistent with well-settled principles of statutory construction, *see Sutherland Stat. Const.* § 47.23 (5th ed. 1992), this Court found that, by directly addressing the question of state taxation of aviation fuel and specifying which taxes could not be imposed, the federal government was thereby consenting to the imposition

of other state taxes, including the state tax at issue in that case. *Id.* at 10.

With respect to the 1966 Resolution, on the other hand, even though it endorsed an international scheme to exempt fuel "from all customs and other duties," the Court found that this did not negate the congressional policy reflected in the 1944 Chicago Convention. The Resolution was found not to be action by the government of the United States but merely the work product of an organization to which the United States belonged.

The Convention established the context within which the Court considered the subsequent bilateral aviation agreements with foreign countries. In light of the Convention and the Resolution, both of which specifically addressed the concern of subnational taxation, the Court found that the express language of the agreements precluding only national taxes on aviation fuel reflected a conscious decision by the federal government to allow the state taxes at issue in the case. The Court therefore concluded that "the Federal Government has affirmatively decided to permit the states to impose these taxes on aviation fuel" (477 U.S. at 12) and dormant Commerce Clause analysis was inappropriate.

The affirmative action found to establish consent in *Wardair* stands in stark contrast to the five items of inaction relied on by the California Supreme Court to support the proposition that Congress has consented to states' use of worldwide combined reporting. These five items of inaction were:

1. Failure to consider state taxes in any income tax treaties with foreign nations, except in nondiscrimination clauses;
2. The absence of any provision restricting state taxes of any sort in various model income tax treaties;
3. The absence of restrictions on state taxation in Friendship, Commerce & Navigation ("FCN") treaties to which the United States is a party;

4. The absence of enacted congressional legislation prohibiting or restricting the worldwide unitary method; and
5. Failure to obtain the necessary two-thirds vote to ratify a treaty containing a provision prohibiting use of the worldwide unitary method by the states.

The first three factors relied on by the California Supreme Court neither directly address nor, indeed, even consider the question of worldwide combined reporting at the subnational level. The treaties, while requiring use of separate accounting at the national level, are *silent* on the issue of separate accounting at the state level. Yet the California Supreme Court found that "an extensive pattern of executive branch-negotiated diplomatic texts parallels, in our view, Congress' own unwillingness to disallow legislatively the states' application of formula apportionment methods to foreign controlled multinational taxpayers, and bespeaks a coordinate 'acquiescence.'" (Pet. App. C-34.)

Such a suggestion is absurd. If congressional consent is to retain any meaning, it cannot be held that an expression of a federal preference for one method of taxation (separate accounting) constitutes congressional consent to states' use of another method of taxation (worldwide combined reporting). Indeed, if such an analysis is allowed to stand unchallenged, any treaty that regulated federal taxation at the national level, or failed to consider a particular state taxation method, would reflect a conscious congressional decision to allow states to tax in any manner they please. Such a result would render dormant Commerce Clause analysis obsolete. If the Senate ratified a treaty which included a provision specifically prohibiting or permitting a state taxation method, clearly dormant Commerce Clause analysis would be irrelevant; similarly, however, under the California Supreme Court's approach, if that same treaty were silent on the issue of state taxation, that silence would reflect affirmative approval of and consent to any particular taxing method used by the states, thereby also rendering dormant Commerce Clause analysis irrelevant.

The California Supreme Court's finding that these treaties "parallel[] the *Wardair* paradigm" (Pet. App. C-34) is also inapt. The treaties at issue in this case are vastly different from the bilateral agreements at issue in *Wardair*. In *Wardair*, the specific subject matter encompassing the tax at issue had been addressed in both the Chicago Convention and the Resolution. The subsequent bilateral agreements were therefore entered into in the context of these foundational documents. The absence of reference to state taxation reflected a congressional policy to leave unchanged the state tax boundaries established by those earlier documents. In contrast, the treaties and other bilateral agreements at issue in this case did not emanate from any congressional understanding on the subject of state taxation of the income of multinational corporations. Rather these treaties were negotiated and entered into in the context of congressional silence on the subject of state taxation of multinationals and therefore no congressional intent can be attributed to the absence of state taxation regulation.

The California Supreme Court asserted that the tax treaties' nondiscrimination clauses applicable to the states demonstrates that state taxation was in fact at issue in these treaties. Again, however, it is hard to see how a general provision precluding states from taxing foreign corporations at a higher rate than domestic corporations implicates the question of states' use of worldwide combined reporting so that the failure to consider that issue in these treaties can be deemed to reflect congressional policy. Moreover, this general reference to state taxation stands in stark contrast to the specific congressional consideration of the particular subnational tax at issue in the Chicago Convention. Surely, if congressional consent is to have any substantive meaning, then a general nondiscrimination provision cannot give rise to a *Wardair* "negative implication."

The negative implications of these treaties are, therefore, quite different from the negative implications of the bilateral agreements in *Wardair*. Indeed, what this Court found in *Wardair* was that there "was not the federal governmental silence of the sort that triggers dormant Commerce Clause analysis" because "the Federal Government *has affirmatively acted, rather than remained silent*." 477 U.S. at 9 (emphasis supplied).

This distinction is significant when considering the fourth factor found to be significant by the California Supreme Court — the absence of enacted congressional legislation prohibiting or restricting the use of worldwide combined reporting to foreign-based multinationals. Failure to enact legislation is clearly not "affirmative action" of the type that can be considered in any *Wardair*-type analysis.

The only factor that specifically addresses the application of worldwide combined reporting to foreign-based enterprises is the last. However, this factor provides no more insight into congressional policy than the prior four. In 1975, the Executive Branch negotiated an income tax treaty[1] with the United Kingdom that contained a provision, article 9(4), that would have prohibited the states' application of worldwide combined reporting to U.K.-based groups. Senator Frank Church introduced a "reservation" to 9(4) in the Senate Foreign Relations Committee which would have effectively removed 9(4) from the treaty. This Church reservation was *defeated* 10 to 5 in the Senate Foreign Relations Committee. The reservation was then voted upon on the Senate floor, and, again, *defeated* 44 to 34. The treaty with article 9(4) included received a favorable vote of 49 to 32, falling only 5 votes short of the required two-thirds vote necessary for the ratification of a treaty. Finally, 9(4) was reserved without a vote and the treaty was ratified with the reservation.[2]

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[1] Convention for the Avoidance of Double Taxation, Dec. 31, 1975, U.S.-U.K., 31 U.S.T. 5668, TIAS 9682 (entered into force Apr. 25, 1980).

[2] One Senator suggests that it was a mere quirk of congressional procedure that article 9(4) was not included in the treaty: "Last Friday, we rejected the Church reservation by a comfortable majority, only to find it reappear in today's version of the vote. Thus we combined two issues, one which requires only a majority vote, namely the Church reservation, and ratification of the treaty and its protocols which require a two-thirds vote. I would have very much preferred to follow the original suggestion of the Senator from West Virginia, made last Friday, to have two votes back to

It is from these three majority votes in favor of *prohibiting* states' use of worldwide combined reporting that the California Supreme Court found a congressional policy *permitting* states' use of worldwide combined reporting. Ignoring the majority votes in favor of 9(4), the California Supreme Court focused its attention on the failure to achieve the two-thirds majority necessary to ratify the treaty with article 9(4) included. It is always dangerous to speculate on the meaning of congressional inaction, but it appears from the congressional record that the merits of worldwide combined reporting were not the primary focus of the debate surrounding article 9(4). Rather the failure to ratify the treaty with article 9(4) included seems to reflect more the concern of the Senate that the treaty ratification process was not the appropriate forum to consider such a curb on states' powers. The more appropriate forum was Congress. One senator expressed it as follows:

> Now that the State authority has been confirmed by judicial opinion, this treaty seeks to curb that power by treaty negotiation — not by constitutional amendment and not by act of Congress.
>
> I cannot support such unwarranted extension of the Executive's power, and must vote for the Church reservation on article 9(4).

Remarks of Senator Matsunaga, 124 Cong. Rec. 18,669 (1978). Similarly, Senator Church, who introduced the reservation, expressed his concern thus:

> There are two important principles at stake in this treaty. The first concerns the role of tax treaties in our constitutional system. Whatever tax treaties are good for, they should not be used to usurp for the executive branch of Government the power to impose major changes in internal tax policy. Yet the United Kingdom Treaty does precisely this.

---

back, thereby keeping votes and issues apart. I am convinced that in this case we would have had a treaty today including article 9(4)." Remarks of Senator Morgan, 124 Cong. Rec. 19,078 (1978).

> . . .
>
> The second important principle concerns the proper way for resolving disputes within our federal system....
>
> Mr. President, Congress is the forum in which disputes within the federal system are meant to be resolved.

Remarks of Senator Church, 124 Cong. Rec. 18,416-17 (1978). Ironically, the senatorial failure to ratify the treaty is the "action" that California Supreme Court points to as most clearly showing *congressional* consent for states' use of worldwide combined reporting. Yet in the view of the senators at least, if not the California Supreme Court, *Congress* had not even considered, let alone approved of, worldwide combined reporting.

It is not surprising, therefore, that the California Supreme Court, when reviewing the five factors considered above, heard "the din of a 'governmental silence'." (Pet. App. C-26).[3] What is surprising is that the lower court found that it was a din "that cannot be ignored" (Pet. App. C-26). Certainly, this Court has found that the five "inactions" could, and should, be ignored. Each of the five items alleged here as indications of congressional consent to use of the worldwide unitary method of taxation existed prior to the United States Supreme Court's decision in *Container Corporation of America v. Franchise Tax Board*, 463 U.S. 159 (1983). The *Container* decision refers to the income tax treaties in general, the model treaties, the failure of Congress to take action, and the reservation with respect to the U.K. treaty. The FCN treaties were discussed in the Franchise Tax Board's brief in *Container*, but were not mentioned in the *Container* opinion. (*Container Corporation of America v. Franchise Tax Board*, *supra*, Appellee's brief at 126-29.) Yet this Court did not find that Congress had consented to the worldwide unitary method of taxation but rather that dormant Commerce Clause analysis was appropriate. Nothing has changed.

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[3] "Din" is defined in *Webster's Third New International Dictionary* (1976) as "a loud noise; *esp.* a welter of confused or discordant sounds." *Id.* at 635.

CONCLUSION

The instances of congressional inaction at issue in this case, whether taken collectively or individually, are inconsistent with any plausible view of consent. If the California Supreme Court's decision is allowed to stand the concept of congressional consent will become meaningless and the scope of the dormant Commerce Clause severely restricted. We therefore urge this Court to grant the Petition for a Writ of Certiorari in this case and to give plenary consideration to this matter.

Dated: April 20, 1993.

Respectfully submitted,

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No. 92-1384

IN THE
Supreme Court of the United States
OCTOBER TERM, 1992

BARCLAYS BANK PLC,
Petitioner,
v.
FRANCHISE TAX BOARD,
Respondent.

On Petition for Writ of Certiorari to the Court of Appeal of the State of California, Third Appellate District

**BRIEF FOR
NATIONAL FOREIGN TRADE COUNCIL, INC.,
NATIONAL ASSOCIATION OF MANUFACTURERS,
CHAMBER OF COMMERCE OF THE
UNITED STATES OF AMERICA,
THE BUSINESS ROUNDTABLE,
UNITED STATES COUNCIL FOR
INTERNATIONAL BUSINESS,
EMERGENCY COMMITTEE FOR AMERICAN TRADE,
AMERICAN PETROLEUM INSTITUTE,
CHEMICAL MANUFACTURERS ASSOCIATION,
FINANCIAL EXECUTIVES INSTITUTE,
THE TAX COUNCIL, AND
CALIFORNIA CHAMBER OF COMMERCE
AS AMICI CURIAE IN SUPPORT OF PETITIONER**

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BRIEF FOR NATIONAL FOREIGN TRADE COUNCIL, INC., NATIONAL ASSOCIATION OF MANUFACTURERS, CHAMBER OF COMMERCE OF THE UNITED STATES OF AMERICA, THE BUSINESS ROUNDTABLE, UNITED STATES COUNCIL FOR INTERNATIONAL BUSINESS, EMERGENCY COMMITTEE FOR AMERICAN TRADE, AMERICAN PETROLEUM INSTITUTE, CHEMICAL MANUFACTURERS ASSOCIATION, FINANCIAL EXECUTIVES INSTITUTE, THE TAX COUNCIL, AND CALIFORNIA CHAMBER OF COMMERCE AS AMICI CURIAE IN SUPPORT OF PETITIONER

INTEREST OF THE AMICI CURIAE

The amici curiae are organizations representing a wide spectrum of U.S. business interests, including both large and small, domestic and multinational, and U.S.- and foreign-owned companies. All share a strong commitment

to principles of domestic and international free trade. Each is concerned that California's taxation of foreign-owned multinational businesses under a worldwide combined reporting method impairs U.S. foreign economic relations, threatens to incite destructive retaliatory measures by foreign governments, and endangers U.S. business and the U.S. economy. International economic tensions, and especially the threat of foreign reprisals, artificially impede U.S. trade and restrict the flow of capital in global markets, dampening both foreign investment in the United States and U.S. investment abroad. Amici believe that Question 1 presented by the petition for certiorari in this case requires resolution by this Court to avert these undesirable consequences.

Additional information about each of the amici curiae is set forth in the Appendix hereto.

Counsel for the parties have consented to the filing of this brief in letters filed with the Clerk of the Court.

SUMMARY OF ARGUMENT

This case squarely presents the question expressly reserved by this Court in *Container Corp. v. Franchise Tax Board*, 463 U.S. 159 (1983): whether the Foreign Commerce Clause permits California to tax the income of a foreign-owned unitary business under the worldwide combined reporting method. The Court in *Container* upheld California's worldwide method as applied to a U.S.-owned business. The decision's rationale requires a different result in the case of a foreign-owned business.

The Court in *Container* concluded that California's worldwide unitary tax did not seriously threaten the ability of the United States to speak with "one voice" in conducting foreign affairs. In the absence of Executive Branch guidance, the Court saw little reason to suppose that a tax levied on a domestically based multinational business would "justifiably lead to significant foreign retaliation." 463 U.S. at 194.

Here, by contrast, the Secretary of State advised the Governor of California that the state's worldwide unitary tax method "has become a source of conflict with foreign states," "has seriously complicated our economic relations with many of our closest allies," has triggered formal protests "from virtually every developed country in the world," and "greatly impair[s] the ability of the federal government to carry out its tax and investment policy in the international arena." Pet. App. H44-45. The United States, appearing as amicus curiae before the California Supreme Court, advised that the state's taxing method "is in conflict with the internationally accepted standard and policies," "has caused serious disputes and difficulties for the United States in the conduct of foreign affairs," and "constitutes an impermissible interference in the conduct of the nation's foreign affairs." *Id.* at H18, H35-36. Moreover, as the California Court of Appeal stated, "we do not have to speculate on whether the taxation method at issue may offend our foreign trading partners and lead them to retaliate against the nation as a whole. They are offended; they have retaliated." *Id.* at B27 (citation omitted).

Differences of both principle and practicality explain why the foreign reaction is so much stronger when California applies its tax to a foreign-based company. First, it is a fundamental precept of international law, and an underlying theme of *Container*, that a nation may tax its own domiciliaries as it chooses. The balance of interests shifts when one nation seeks to tax the domiciliary of another in a manner at odds with international norms. Second, the record here demonstrates that the compliance burdens for foreign companies far exceed those for domestic companies, thereby adding a discriminatory gloss to an already aberrant tax system.

The California Supreme Court refused to weigh these considerations despite their obvious importance to the analysis prescribed by *Container*. In its view, this Court's decision in *Wardair Canada Inc. v. Florida Dep't of Reve-*

nue, 477 U.S. 1 (1986), "reoriented" and "reduced the scope" of the dormant Foreign Commerce Clause doctrine (Pet. App. C19), allowing courts to infer from Congressional *silence* a federal decision to acquiesce in a particular form of state taxation. *Wardair* did no such thing. On the contrary, it held that Florida could lawfully tax sales of aviation fuel to foreign as well as domestic airlines because Congress had "*affirmatively acted* [on the subject], rather than remained silent." 477 U.S. at 9 (emphasis added). Nothing in *Wardair* or any other decision of this Court supports the California Supreme Court's novel theory that Congressional *in*action can validate a state statute that otherwise would violate the Commerce Clause.

Plenary review by this Court is needed to stave off a potentially destructive cycle of international retaliation that would interfere with foreign trade, disrupt international flows of capital and technology, and harm U.S. commercial interests abroad.

ARGUMENT

I. CALIFORNIA'S WORLDWIDE UNITARY TAXATION, AS APPLIED TO FOREIGN-OWNED MULTINATIONAL BUSINESSES, VIOLATES THE FOREIGN COMMERCE CLAUSE

A. California's System Impairs Federal Uniformity and Prevents the Federal Government from Speaking with One Voice in Its Commercial Relations with Foreign Governments

In granting to Congress the "Power . . . [t]o regulate Commerce with foreign Nations," Art. I, § 8, cl. 3, the Framers recognized that "[f]oreign commerce is preeminently a matter of national concern." *Japan Line, Ltd. v. County of Los Angeles,* 441 U.S. 434, 448 (1979). This Court accordingly has held that a state tax is unconstitutional under the Foreign Commerce Clause if it "prevents the Federal Government from 'speaking with

one voice when regulating commercial relations with foreign governments.'" *Id.* at 451 (quoting *Michelin Tire Corp. v. Wages,* 423 U.S. 276, 285 (1976)).

In *Container,* the Court upheld California's worldwide combined reporting method of taxation as applied to a U.S.-owned multinational unitary business.[1] The Court expressly reserved the question whether the California system would be lawful as applied to "domestic corporations with foreign parents or foreign corporations with either foreign parents or foreign subsidiaries." 463 U.S. at 189 n.26. This case presents precisely that question.

1. The record here leaves little room for doubt that California's worldwide combined reporting method, as applied to foreign-owned businesses, offends the Foreign Commerce Clause. It is one thing for a sovereign nation to tax (or allow a subnational authority to tax) its own corporate domiciliaries under a system at odds with international norms. It is a far more provocative thing to tax *foreign* businesses under an internationally disfavored system, particularly if the taxing nation has been the principal proponent of the prevailing international standards. That is this case.

The trial court found that the arm's-length/separate accounting method of taxation "is universally used and favored" while worldwide combined reporting "is everywhere disliked." Pet. App. A21; *see also id.* at C8 n.6. As the Court of Appeal observed, "no other country in the world uses [worldwide combined reporting]." *Id.* at

---

[1] Under the "worldwide combined reporting method," a taxpayer aggregates the income of all the entities in its unitary business throughout the world and apportions a share of the total to California under the familiar three-factor formula of property, payroll, and sales. Under the "arm's-length/separate accounting method," by contrast, each corporation is treated as a separate entity taxable only by the jurisdictions in which it operates and only on its own income; transfers between affiliated entities are deemed to occur at arm's length and must be reported on that basis in determining taxable income.

B23. California's departure from the international norm and its embrace of a deviant method excites particularly strong reactions from the international community because of "the critical role the United States has played in attempting to construct a coherent and nondiscriminatory tax policy for all nations based on the [arm's-length] method." *Id.* at B26. It is of no comfort to other nations that the tax at issue is imposed by a state rather than the federal government. As petitioner notes (Pet. 25), if California were a separate nation, its economy would rank seventh or eighth in the world. It is no wonder that its tax policies have global reverberations.

The worldwide combined reporting method imposes far more costly compliance burdens on foreign-owned than on U.S.-owned unitary groups. As the Secretary of State explained in a letter to the Governor of California, "[t]he information required by the tax authorities of the jurisdiction practicing a worldwide unitary method of taxation may not be readily available to the enterprise and . . . will require costly conversion into a form usable by the jurisdiction's tax authority." Pet. App. H44-45. Indeed, the trial court found that "literal compliance . . . is impossible, because no foreign multi-national maintains appropriate accounting books." *Id.* at A27. The cost to reconstruct the necessary information for past periods would be "prohibitive"; the cost to set up and maintain systems to obtain the information for future periods would be so "huge" that even the state conceded the burden would be unreasonable. *Id.* at A27-28. The California Court of Appeal aptly characterized the compliance problem as an "administrative nightmare for the foreign-based multinational." *Id.* at B25.

Not surprisingly, the worldwide combined reporting method of state taxation has provoked an "international furor" (*id.* at A24), bringing the United States into unprecedented economic conflict with its trading partners. The Secretary of State advised the Governor of California

that the United States "has received diplomatic notes complaining about state use of the worldwide unitary method of taxation from virtually every developed country in the world." *Id.* at H45. The record reflects that "[t]hese protests have been sharp, frequent, and incessant over a number of years." *Id.* at B22.

The threat of international economic retaliation against United States interests is very real. Indeed, the United Kingdom, frustrated by this nation's inability to eliminate worldwide combined taxing methods, adopted retaliatory legislation in 1985. The measure withdraws from U.S. parent corporations operating in worldwide combination states certain tax benefits relating to the payment of dividends by U.K. subsidiaries. *See id.* at B22-23. Although the United Kingdom has thus far deferred implementation of the legislation while awaiting the outcome of litigation in the U.S. courts, concerns about possible retroactive penalties "impelled many American companies into preimplementation compliance" (*id.* at B23), with the result that some companies altered their normal policy for the repatriation of dividends from U.K. subsidiaries and declined to claim benefits properly available to them under the applicable treaty. *Id.* at H45.

U.S. trading partners have expressed their displeasure in other ways as well. For example, some nations have cancelled trade missions to states that applied worldwide combined reporting methods to foreign-based multinationals. *Id.* at B23. According to the Secretary of State, tensions over this issue have "seriously complicated our economic relations with many of our closest allies" and have been "partially responsible for stalling some bilateral tax treaty negotiations." *Id.* at H45. In his view, "[c]ontinued state taxation on a worldwide unitary basis will greatly impair the ability of the federal government to carry out its tax and investment policy in the international arena and to manage the sensitive issue of international double taxation." *Id.*

In sum, in the words of the Secretary of State, "world-wide unitary taxation is adversely affecting the United States' foreign economic relations." *Id.* The United States, appearing as amicus curiae, accordingly advised the California Supreme Court that it considers the state's taxing method "an egregious interference with the Federal Executive's conduct of foreign affairs." *Id.* at H25 n.13. While pursuing its tax policy according to its own parochial interests, California has thus hobbled the federal government in its pursuit of important foreign economic policy goals and has placed the whole nation at risk of international commercial retaliation.

2. The Foreign Commerce Clause was meant to foreclose just such inappropriate state intrusions into international affairs. The Articles of Confederation had restricted the power of the national government and had given the states broad authority over foreign commerce. That experiment failed, *see Brown v. Maryland,* 25 U.S. (12 Wheat.) 419, 445-46 (1827), and the Constitution marked a dramatic reversal. In place of the states' "partial and separate regulations," 1 J. Elliot, *Debates on the Federal Constitution* 114 (2d ed. 1888), the Convention of 1787 sought a "vigorous national government . . . directed to a common interest." *The Federalist No. 11*, at 69 (Hamilton) (J. Cooke ed., 1961). The Framers believed that, "[i]f we are to be one nation in any respect, it clearly ought to be in respect to other nations." *The Federalist No. 42,* at 279 (Madison) (J. Cooke ed., 1961). The Foreign Commerce Clause accordingly reassigned from the states to Congress the power "to regulate Commerce with foreign nations."

The Framers recognized that an individual state, acting in furtherance of its own commercial interests, might enact legislation that would incite foreign reprisals. Even though provoked by a single state's tax measure, such commercial retaliation "of necessity would be directed at American [interests] in general, not just that of the

taxing State, so that the Nation as a whole would suffer." *Japan Line,* 441 U.S. at 450. *See also Kraft General Foods, Inc. v. Iowa Dep't of Revenue & Finance,* 112 S. Ct. 2365, 2370 (1992). The Foreign Commerce Clause thus sought to ensure that measures bearing a high risk of international commercial discord would lie within the sole discretion of the national government, acting in the collective self-interest of all the states, rather than within the power of each individual state acting by its own lights. "If it be otherwise, a single State can, at her pleasure, embroil us in disastrous quarrels with other nations." *Chy Lung v. Freeman,* 92 U.S. 275, 280 (1876).

That is what California has done in the case of its worldwide combination method of taxation. As the trial court found, "[t]his case factually demonstrates as extreme an example of predictable international consequences stemming from a local tax as can be conceived." Pet. App. A23. This Court's words in *Japan Line* apply here with equal force: "California, by its unilateral act, cannot be permitted to place these impediments before this Nation's conduct of its foreign relations and its foreign trade." 441 U.S. at 453.

B. Congressional Silence Cannot Validate an Otherwise Unconstitutional State Statute

The California Supreme Court did not dispute that dormant Foreign Commerce Clause considerations would require invalidation of the state's tax method. In fact, the court acknowledged that Barclays' argument might have carried force had it been presented "in the immediate aftermath of the *Container* decision." Pet. App. C19. The court held, however, that this Court's decisions after *Container* "reoriented" (*id.*) the dormant Foreign Commerce Clause doctrine, making resort to traditional considerations inappropriate (and apparently rendering *Container* inoperative) whenever a court infers from

Congressional *inaction* a legislative intention to permit the state taxation at issue. As the California Supreme Court put it, this Court's recent jurisprudence "reflects a diminution in the reach of dormant foreign commerce clause analysis in favor of an expanded recognition that, under circumscribed conditions, *governmental silence* may constitute a ratification of state taxation of foreign commerce, rendering a dormant analysis inapposite." *Id.* at C4 (emphasis added).

This novel theory rests on a dangerous misreading of this Court's precedents. It is true, of course, that when Congress has "taken affirmative action" expressly consenting to a form of state taxation, the courts are not free to invalidate the tax under the dormant Commerce Clause. ***Prudential Insurance Co. v. Benjamin***, 328 U.S. 408, 421 (1946). It is equally true, however, that only a clear expression of Congressional consent will suffice to validate an otherwise unconstitutional state law. As the Court reiterated only last Term, "Congress must manifest its *unambiguous* intent before a federal statute will be read to permit or approve . . . a violation of the Commerce Clause." ***Wyoming v. Oklahoma***, 112 S. Ct. 789, 802 (1992) (emphasis added). ***See also Maine v. Taylor***, 477 U.S. 131, 138-39 (1986); ***Sporhase v. Nebraska ex rel. Douglas***, 458 U.S. 941, 960 (1982). Indeed, "[t]he need for affirmative approval is heightened" when a state's policy "has substantial ramifications beyond the Nation's borders"; in those circumstances, "[t]he need for a consistent and coherent foreign policy . . . enhances the necessity that congressional authorization not be lightly implied." ***South-Central Timber Development, Inc. v. Wunnicke***, 467 U.S. 82, 92 n.7 (1984).

The California Supreme Court identified no "affirmative" Congressional action authorizing the use of worldwide unitary taxation. Instead, it relied primarily on the Senate's narrow failure in 1978 to ratify a bilateral

income tax convention that included a prohibition against the worldwide unitary method. Pet. App. C27-31. As the Court of Appeal noted, however, the Senate voted 49 to 32 to *approve* the convention, falling only five votes short of the necessary 2/3 majority. *Id.* at B20. Opposition to the relevant provision, moreover, "was rooted not in the substance of the article but in the procedural wariness of addressing the problem through patchwork treaties rather than through comprehensive legislation." *Id.* In these circumstances, the Senate's ultimate approval of the convention without the controversial restriction can hardly be construed as an affirmative endorsement of the state laws to which that restriction was directed.

The California Supreme Court mistakenly believed that this Court's decision in *Wardair Canada Inc. v. Florida Dep't of Revenue*, 477 U.S. 1 (1986), prescribed a "protocol for identifying those kinds of governmental silences" that imply federal ratification of a state's power to impose a challenged tax. Pet. App. C23. To the contrary, this Court in *Wardair* emphasized that "we do *not* confront federal governmental silence" because "the Federal Government has *affirmatively acted*, rather than remained silent." 477 U.S. at 9 (emphasis added). It also reaffirmed the rule, overlooked by the California Supreme Court, that when the federal government "has *not* affirmatively acted, . . . it is the responsibility of the judiciary to determine whether action taken by state or local authorities unduly threatens the values the Commerce Clause was intended to serve." *Id.* at 7 (emphasis added).

The California court's mistake was not merely semantic. The question in *Wardair* was whether the Foreign Commerce Clause precluded Florida from applying to foreign airlines a sales tax on aviation fuel purchased within the state. The Federal Aviation Act, in a section entitled "State taxation of air commerce," expressly pro-

hibited certain forms of state taxation and expressly authorized others. Among the authorized state taxes were "sales or use taxes on the sale of goods or services." *Id.* at 6-7. That was enough for Chief Justice Burger, who concluded in a concurring opinion that "the Florida tax —even in the area of foreign air commerce—is expressly authorized by Congress." *Id.* at 17. The majority, however, looked beyond the face of the statute for confirmation that Congress intended to authorize state sales taxes in the case of foreign as well as domestic carriers.

The Court did not have to look far. An international convention to which the United States was a party precluded local fuel taxes "only when the fuel is 'on board an aircraft . . . on arrival . . . and retained on board on leaving' a contracting party; it [did] *not* prohibit taxation of fuel purchased in that country." *Id.* at 10 (emphasis added). The convention thus reflected an affirmative decision "curtailing and limiting only some of the localities' power to tax [aviation fuel], while implicitly preserving other aspects of that authority." *Id.* Unlike this case, where Congress has taken no affirmative action at all on the issue of worldwide combined reporting, it was clear in *Wardair* that "the Federal Government has not remained silent" but "has affirmatively decided to permit the States to impose these sales taxes on aviation fuel." *Id.* at 12.

The California court's misguided holding that governmental silence can ratify an otherwise unconstitutional state taxing regime thus finds no support in this Court's precedents. It is also unworkable, requiring courts to distinguish between "species" of Congressional silence that remain constitutionally neutral and those that are supposedly "eloquent." Pet. App. C21, C38. This quixotic inquiry, which defies meaningful guidance or limitation, is likely to produce capricious and inconsistent outcomes incompatible with this Court's traditional insistence upon an explicit and unambiguous expression of Congressional consent.

II. THE ISSUE HAS ENORMOUS PRACTICAL IMPORTANCE FOR THE U.S. ECONOMY

In the 10 years since this Court's decision in *Container*, perhaps no other U.S. legal issue has been the subject of more widespread and intense international concern than the constitutionality of worldwide unitary taxation as applied to foreign-owned multinationals. A number of our major trading partners have already threatened economic reprisals against the United States unless the worldwide unitary issue is resolved compatibly with international norms. Allowing the California decision to stand could well provoke a cascade of international retaliatory actions, the consequences of which for the U.S. economy, for U.S.-owned foreign businesses, and for the global economy as a whole are likely to be extremely damaging. At a minimum, government-imposed economic countermeasures will almost certainly skew international investment decisions, disrupting the flow of foreign capital into the United States and reducing the attractiveness of foreign investment for U.S. businesses. If other nations were to follow the lead of the United Kingdom, for example, it may become significantly more costly for U.S. subsidiaries abroad to repatriate dividends to their domestic parent corporations. That additional cost would necessarily enter into any investment determination by a U.S. business, with the result that capital is likely to be deployed in other than the most efficient manner.

This case is unusually well postured for review. The legal issue is squarely framed. The record is exceptionally complete. All three courts below have addressed the facts and the law at substantial length. The Commerce Clause question can be answered definitively only by this Court, and this case provides an excellent vehicle for resolving it.

CONCLUSION

The petition for writ of certiorari should be granted.

Respectfully submitted,

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APRIL 1993

APPENDIX

APPENDIX

This brief is submitted on behalf of the following amici curiae:

National Foreign Trade Council, Inc.

The National Foreign Trade Council, established in 1914, consists of approximately 500 manufacturing companies, financial institutions, and other firms with substantial international operations and interests. Its members account for more than 60 percent of all U.S. non-agricultural exports and 60 percent of all U.S. private foreign investment. The NFTC's purpose is to develop policies designed to expand exports, protect U.S. foreign investment, enhance the competitiveness of U.S. industry, and promote and maintain a fair and equitable international trading system.

National Association of Manufacturers

The National Association of Manufacturers is a non-profit voluntary business association consisting of more than 12,000 manufacturing and related businesses operating in the United States and worldwide. NAM supports a taxing system that encourages the competitiveness of U.S. manufactured goods in domestic and foreign markets.

Chamber of Commerce of the United States of America

The U.S. Chamber of Commerce is the largest federation of business companies and associations in the world. With substantial membership in each of the 50 states, the Chamber represents approximately 215,000 businesses and organizations and serves as a major voice of the American business community. It has a strong interest in tax measures that impact on the competitiveness of U.S. industry and on the U.S. economy.

The Business Roundtable

The Business Roundtable is an association of approximately 200 member companies represented by their chief executive officers. The members are substantial companies engaged in a wide variety of domestic and multinational businesses, and they face intense competition from domestic and foreign rivals. The Business Roundtable examines public issues that affect the economy and develops positions that seek to reflect sound economic and social principles.

United States Council for International Business

The United States Council for International Business advances the global interests of American business both at home and abroad. It is the American affiliate of the International Chamber of Commerce, the Business and Industry Advisory Group to the Organization for Economic Development and Cooperation, and the International Organization of Employers. The Council officially represents U.S. business positions in the main intergovernmental bodies and in dealings with foreign business and foreign governments. Working with its membership of about 300 corporations, law firms, and associations, the Council addresses policy issues affecting an increasingly globally oriented American business community. Its objective is to promote an open system of world trade, finance, and investment.

Emergency Committee for American Trade

The Emergency Committee for American Trade is an organization of the leaders of approximately 60 large U.S. firms with extensive international business operations. Their annual worldwide sales total well over $1 trillion, and they employ more than five million workers. ECAT's mission is the advocacy of open international economic policies that will expand international trade and investment.

American Petroleum Institute

The American Petroleum Institute is a trade association that represents approximately 300 companies involved in all aspects of the oil and gas industry, including exploration, production, transportation, refining, and marketing. Many of its members conduct extensive business operations in foreign countries. API's mission includes promoting the interests of the petroleum industry in the development of national policy conducive to a favorable domestic and international business environment.

Chemical Manufacturers Association

The Chemical Manufacturers Association is a non-profit trade association whose member companies represent more than 90 percent of the productive capacity for basic industrial chemicals in the United States. The U.S. chemical industry provides jobs for 1.1 million American workers. In 1991, the chemical industry was the largest exporting sector of the U.S. economy, with exports of $43 billion that produced a net trade surplus of $18.2 billion. CMA and its members have a vital interest in issues affecting international trade and U.S. foreign economic relations.

Financial Executives Institute

The Financial Executives Institute, founded in 1931, is a professional association of 14,000 senior financial executives representing over 8,000 major companies throughout the United States and Canada. Through its technical committees, FEI formulates positions on a variety of tax, employee benefits, international trade, and public policy issues of concern to corporate financial executives.

The Tax Council

The Tax Council is an organization of approximately 100 business members with wide representation in manufacturing, mining, energy, electronics, transportation, pub-

lic utilities, consumer products and services, retailing, and banking and other financial services. The Council's mission is to serve as a forum representing the views of the overall business community on issues of U.S. domestic and foreign tax policy.

California Chamber of Commerce

The California Chamber of Commerce represents 5,000 member companies, 160 member trade associations, more than 400 affiliated local chambers of commerce, and a statewide network of 168,000 small business owners. Its members include firms of all sizes from every industry throughout California. Among the Chamber's missions is to help member firms stay competitive in the fast-changing global marketplace and to promote their interests in matters affecting international trade.

No. 92-1384

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SUPREME COURT OF THE UNITED STATES

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Petitioner,
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FRANCHISE TAX BOARD,
AN AGENCY OF THE STATE OF CALIFORNIA
Respondent.

ON PETITION FOR WRIT OF CERTIORARI TO THE COURT APPEAL OF THE STATE OF CALIFORNIA IN AND FOR THE THIRD APPELLATE DISTRICT

BRIEF OF ORGANIZATION FOR INTERNATIONAL INVESTMENT INC. AND UNION OF INDUSTRIAL AND EMPLOYERS' CONFEDERATIONS OF EUROPE AS *AMICI CURIAE* IN SUPPORT OF *CERTIORARI*

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No. 92-1384

IN THE

SUPREME COURT OF THE UNITED STATES

October Term 1992

Barclays Bank PLC
Petitioner,

v

Franchise Tax Board,
An Agency of the State of California
Respondent.

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INTEREST OF AMICI CURIAE

The Organization for International Investment Inc. ("OFII") is a non-profit corporation the members of which are United States subsidiaries of foreign

shareholders.[1] The Union of Industrial and Employers' Confederations of Europe ("UNICE") is recognized as the official spokesman for European business and industry vis-a-vis the European Economic Community and other European institutions.[2]

OFII members are domestic companies engaged in manufacturing, distributing goods, and performing services within the United States. OFII members export manufactured and processed goods and import various articles. OFII represents members' interests in matters of federal and State taxation and seeks legislative and judicial solutions to problems affecting economic interests of its members. OFII members have a direct and vital interest in the international aspects of the tax issues presented by this case. Similarly to the petitioners, OFII members bear an increased and discriminatory tax burden under California law. OFII members are treated as unitary with their foreign affiliated companies and are obliged to pay California taxes on foreign source income of companies that do not do business anywhere in the United States. California's scheme of worldwide taxation creates a substantial impediment to international commerce and to investment in the United States by foreign persons.

The member federations of UNICE are the official representatives of all sectors of business and industry in their respective nations. UNICE comprises thirty-three member federations from twenty-two European nations including all European Community and European Free Trade Association nations. UNICE's permanent secretariat is in Brussels, Belgium. An important objective of UNICE is to promote international commerce and investment by eliminating international double taxation. UNICE views California's taxation of foreign source income of companies that do not do business in the United States as a direct impediment to the flow of capital and intellectual

1. A list of OFII members in annexed as Appendix I. Neither the petitioner nor any of its subsidiaries and affiliates are members of OFII.

2. A list of UNICE organizations is annexed as Appendix II.

property between the United States and the nations UNICE represents. UNICE is particularly concerned with the chilling effect the extra-territorial reach of California's unique tax method has on foreign direct investment in the United States.

OFII and UNICE believe it is essential that the United States speak with "one voice" in international taxation matters, as required by this Court's decision in *Japan Line Ltd. v County of Los Angeles.*[3] Departure from *Japan Line* principles poses a severe risk of burdensome and unfair international multiple taxation. The inherent incompatibility between California's worldwide combined reporting method and the internationally accepted arm's length standard inevitably leads to multiple taxation of enterprises represented by the *amici* organizations.

SUMMARY STATEMENT

The Barclays Bank PLC Petition for a Writ of Certiorari seeks review of a decision of the Supreme Court of California that directly confronts the power of the Federal Executive in matters of foreign commerce and taxation of international transactions. In all of its tax treaties and in the Internal Revenue Code, the United States has promoted and adhered to the internationally accepted standard of arm's length, separate entity accounting for division of taxable income by multinational entities. California has expanded its unitary income apportionment method of taxation to include foreign transactions and foreign entities over which neither California nor the United States has jurisdiction. These disparate methods cannot be reconciled. California's disregard of international and federal sourcing-of-income rules inevitably creates a substantial risk of multiple taxation; imposes severe compliance burdens that interfere with the free flow of commerce; and intrudes upon the prerogatives of the federal government in foreign affairs and international commerce. The United States cannot conduct a coherent

3. 441 U.S. 434 (1979).

foreign economic policy — that is, it cannot speak with "one voice" — in the face of a disparate and incompatible income tax method applied internationally by individual States.

The overriding issue in this case is whether the dormant Commerce Clause requires that California's worldwide combined reporting tax regime be restricted to *interstate commerce* where its principles were developed. That issue has not been decided by this Court in the context of domestic corporations with foreign parents or foreign corporations with either foreign parents or foreign subsidiaries. This issue was specifically reserved for decision by this Court in *Container Corp. of America v Franchise Tax Bd.*[4] This case now presents the issue with unusual clarity and, therefore, should be heard by this Court.

In its strained reading of *Wardair Canada Inc. v Florida Dep't of Revenue,*[5] the California Supreme Court has advanced a novel analysis of the dormant Commerce Clause that elevates Congressional inaction to Congressional mandate. If the California judgment is allowed to stand, any State may establish policy affecting foreign commerce of the United States and even contravene federal foreign policy with impunity unless and until interdicted by an act of Congress. The California Supreme Court's decision disregards this Court's precedents and endeavors to supersede federal foreign policy. This Court should grant the petition in this case to settle finally the dormant Commerce Clause issue that has been open for ten years since the decision in *Container Corp.*

STATEMENT OF REASONS FOR TAKING THE CASE

A. THE DECISION BELOW IMPAIRS THE FEDERAL GOVERNMENT'S ABILITY TO CONDUCT FOREIGN RELATIONS.

4. 463 U.S. 159 (1983).
5. 477 U.S. 1 (1986).

The United States adopted the arm's length method many years ago as its standard for allocating income among commonly controlled corporations doing business in more than one nation.[6] This method is reflected in the Internal Revenue Code[7] and is embodied in all bilateral tax treaties to which the United States is a party.[8] The arm's length standard, moreover, is accepted by foreign nations: no foreign nation uses worldwide combined reporting.

No one questions that worldwide combined reporting for tax purposes is incompatible with the arm's length method. The question is whether the United States can maintain and administer uniform standards to divide income among nations if those standards are ignored by individual States. The application of worldwide combined reporting to international commerce by California "... impair[s] the ability of the federal government to carry out its tax and investment policy in the international area" and "has seriously complicated [the United States'] economic relations with many of our closest allies."[9] Its use has been a matter of extreme concern to the United States' trading partners and has already led to harm to the United States as a nation.[10]

The reason for the United States to observe and assure compliance with the international standard is twofold: (1) to secure uniform and equitable treatment of United States business abroad and, correspondingly, (2) to

6. E.g., Foreign Investor's Tax Act, Pub. L. No. 89-809, 80 Stat. 1539 (1966).

7. See I.R.C. § 482 and the income sourcing rules of I.R.C. Subchapter N, §§ 861 — 65.

8. These numerous authorities are collected in the *amicus* brief of the United States filed in the court below, reproduced in Petitioner's appendix at H-10,n.5.

9. Letter to Governor Deukmijian of California, dated Jan. 30, 1986, from Secretary of State George P. Schultz, included in Appendix A of the *amicus curiae* brief of the United States, reproduced in Petitioner's Appendix at H-43.

10. Letter of 30 June 1989, on behalf of the European Community, delivered to the Secretary of State by the Spanish Ambassador, annexed as Appendix IV.

protect as agreed by treaty foreign direct investment in the United States. Neither objective is attainable if a major commercial jurisdiction within the United States ignores the international standard and subjects foreign direct investments to what amounts to economic harassment through double taxation and imposition of excessive compliance costs.

The lower courts that considered this case found on the basis of substantial evidence that California's use of worldwide combined reporting, as applied to foreign-owned corporate groups, violated the Foreign Commerce Clause because it "impair[ed] federal uniformity in an area where federal uniformity is essential" and "prevent[ed] the Federal Government from speaking with one voice when regulating commercial relations with foreign governments."[11]

The precise legal issue presented by this case is whether the United States foreign policy "voice" as expressed by the Executive Branch, combined with Congressional assent in the form of enabling legislation and treaty ratification, is sufficient to invoke the protection of the Foreign Commerce Clause of the United States Constitution for the beneficiaries of that foreign policy.[12]

B. THE DECISION BELOW IS MATERIALLY IN CONFLICT WITH PRIOR DECISIONS OF THIS COURT REGARDING THE DORMANT COMMERCE CLAUSE.

The California Supreme Court has effectively declined to consider the Foreign Commerce Clause issues raised by this case. The California Court chose not to follow the dormant Commerce Clause analysis developed by this Court in *Container Corp.* and *Japan Line*, but,

11. *Japan Line*, 441 U.S. at 448, 451 (citation omitted).

12. This is frequently referred to as the "dormant" Commerce Clause issue. *Franchise Tax Bd. of Cal. v Alcan Aluminium Ltd.*, 493 U.S. 331, 334-35, specifically referred to *Container Corp.* and *Japan Line* as the controlling authorities.

rather, chose to read *Wardair* as a blanket permit removing the State's tax method from scrutiny in the absence of Congressional action expressly forbidding use of the method. This clearly contravenes views recently expressed by this Court in striking down a State tax exclusively levied on foreign dividends.[13]

The distinction between a tax on a "discrete transaction occurring within the State" and one on foreign commerce itself has been carefully restated by this Court in *Itel Containers Int'l Corp. v Huddleston.*[14] The *Itel* opinion's reference to *Wardair*[15] in this context lends no support to the California Supreme Court's convoluted analysis. The *Itel* opinion, indeed, expressly reaffirmed the principles of *Complete Auto Transit, Inc. v Brady*[16] and *Japan Line*, and endorsed the analytical process of *Container.* In view of this recent expression of the appropriate tests to be applied, the California Supreme Court's attempt to postulate a new test for the Commerce Clause based on an unwarranted distortion of *Wardair* is all the more untenable. The opinion below ignores altogether this Court's admonition that "Congress must manifest its unambiguous intent before a federal statute will be read to permit or approve ... [violations] of the Commerce Clause ...."[17] There is, to be sure, nothing in *Wardair* that suggests Congressional silence becomes an endorsement of State action that violates Complete *Auto Transit* and *Japan Line* principles. The court below created a departure from those principles and simply cited the result in *Wardair* as supportive of that departure. No other court has been able

13. *See Kraft General Foods, Inc. v Iowa Dep't of Revenue and Finance*, ____ U.S. ____, 112 S. Ct. 2365 (1992). The dissent, moreover, noted that the case did *not* involve a foreign entity and that the Executive Branch actually *supported* the State's power to levy the tax. It may be surmised, therefore, that both the majority and the dissent would have viewed the instant case more favorably to petitioners.

14. ____ U.S. ____, 113 S. Ct. 1095, 1104 (1993).

15. *Supra*, n. 5.

16. 430 U.S. 274 (1977).

17. *State of Wyoming v State of Oklahoma*, ____ *U.S.* ____, 112 *S.* Ct. 789, 802 (1992).

to discern such a departure in the *Wardair* opinion.[18]

What the California Supreme court chose not to acknowledge was that there was nothing in the facts of *Wardair* that called for dormant Commerce Clause analysis. Congress had expressly permitted the States to levy sales taxes on fuel purchased within their borders. The question in *Wardair* was whether certain international conventions and resolutions modified this clear policy in the case of international flights. This Court found that no such policy could be discerned and, hence, declined to engage in a *Japan Line* style of Commerce Clause analysis. From this rather clear doctrine, the California Supreme Court has posited a wholly new principle: Congressional inaction on a specific issue must be deemed Congressional endorsement of the State's action irrespective of Executive foreign policy. This new principle purportedly would apply here regardless of the obvious conflict with the Internal Revenue Code and the principles found in tax treaties to which the United States is a party. It would also apply regardless of the adverse effect the State's policy may have on the foreign commerce of the United States. This "principle," which effectively stands dormant Commerce Clause analysis on its head, can only be characterized as a perversion of *Wardair*, not an application of it.

This case now comes before this Court after eight and one-half years of litigation on these Foreign Commerce Clause issues in the California court system.[19] It may be anticipated that the respondent, Franchise Tax Board, will urge this Court *not* to address the important foreign commerce issues posed by California's application of worldwide combined reporting in this case and similar cases. The respondent will argue that there is no conflicting federal foreign policy or interference with international

18. This includes the two lower California courts that considered this issue and were unimpressed by the respondent's arguments concerning *Wardair*. See Petitioner's Appendix at A-31, 32 and B-13, 14.

19. Five of those years were spent in the appellate process. The petitioners herein filed their complaint in Superior Court on 30 November 1984. The trial court filed its decision on 20 August 1987.

commerce of the United States to be addressed. But the Foreign Commerce Clause issue presented by this case is too important to be delayed any longer.[20] Worldwide combined reporting continues to interfere with United States foreign policy, to offend the United States' trading partners, and to undercut important federal economic policies. The decision of the California Supreme Court is so patently inconsistent with this Court's prior decisions that it should not be allowed to continue to cast a shadow over the foreign relations and foreign commerce of the United States.

CONCLUSION

For the reasons stated, *amici curiae*, Organization For International Investment and Union of Industrial and Employers' Confederations of Europe, urge this Court to grant the Petition for a Writ of Certiorari.

Respectfully submitted,

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20. The respondent, Franchise Tax Board, has managed to avoid a decision on the merits of the foreign commerce issue for more than ten years in both State and federal courts. See, *e.g.*, *Capitol Indus. — EMI, Inc. v Bennett*, 681 F.2d 1107 (9th Cir.), *cert. denied*, 459 U.S. 1087 (1982); *Shell Petroleum, N.V. v Graves*, 570 F. Supp. 58 (N.D. Cal.), *aff'd*, 709 F.2d 593 (9th Cir.), *cert. denied sub nom. Shell Petroleum N.V. v Franchetti*, 464 U.S. 1012 (1983); *Alcan Aluminium Supra*, n.12. This is the first case in which a foreign parent corporation has been able to claim standing in California courts as a "taxpayer." The California Supreme Court previously has declined to hear cases involving State and local taxation of foreign commerce. Both *Japan Line* and *Container Corp.* were appeals from lower California courts.

APPENDICES

APPENDIX I

ORGANIZATION FOR INTERNATIONAL INVESTMENT INC.

CORPORATE MEMBERS

AKZO AMERICA, INC.
ALCAN ALUMINUM CORPORATION
ALCATEL USA CORPORATION
ASEA BROWN BOVERI, INC.
BASF CORPORATION
BATUS INC.
BET INC.
BP AMERICA CORPORATION
BTR, INC.
BUMBLE BEE SEAFOODS, INC.
BUNGE CORPORATION
CENTRAL SOYA COMPANY, INC.
CIBA-GEIGY CORPORATION
ELF AQUITAINE, INC.
FINA OIL & CHEMICAL CO.
FIREMAN'S FUND INSURANCE COMPANY
GLAXO INC.
GRAND METROPOLITAN INCORPORATED
GUINNESS AMERICA, INC.
HANSON INDUSTRIES
HITACHI, LTD.
HOECHST CELANESE CORPORATION
HOFFMANN-LA ROCHE, INC.
ICI AMERICAS INC.
INSTORIA, INC.
KLOCKNER NAMASCO CORPORATION
LVMH MOET HENNESSY LOUIS VUITTON
MATSUSHITA ELECTRIC CORPORATION OF AMERICA
MINORCO (USA) INC.
NESTLE USA, INC.
NORTH AMERICAN PHILIPS CORPORATION
PEARSON INC.
PECHINEY CORPORATION
PILKINGTON HOLDINGS, INC.
RANK AMERICA, INC.
REED PUBLISHING (USA) INC.
RHONE-POULENC

ROLEX WATCH, U.S.A., INC.
ROLLS-ROYCE INC.
RTZ AMERICA
SANDOZ CORPORATION
SCHINDLER ELEVATOR CORPORATION
S.G. WARBURG & CO. INC.
SIEMENS CORPORATION
SKF USA, INC.
SMITHKLINE BEECHAM
SONY CORPORATION OF AMERICA
SOUTHLAND CORPORATION
TETRA LAVAL
THORN EMI NORTH AMERICA HOLDING, INC.
TOYOTA MOTOR SALES, U.S.A., INC.
UNILEVER UNITED STATES, INC.

APPENDIX II
UNICE MEMBERS

Federation des Entreprises de Belgique (Belgium)
Danish Employers' Confederation (Denmark)
Federation of Danish Industries (Denmark)
Conseil National du Patronat Français (France)
Bundesvereinigung der Deutschen Arbeitgeberverbände — BDA (Germany)
Bundesverband der Deutschen Industrie — EDI (Germany)
Federation of Greek Industries (Greece)
Confederazione of Irish Industry — CII (Ireland)
Federation of Irish Employers — FIE (Ireland)
Confederation Generale dell' Industria Italiana — CONFINDUSTRIA (Italy)
Federation des Industriels Luxembourgeois (Luxembourg)
Verbond van Nederlandse Ondernemingen — VNO (Netherlands)
Nederlands Christelijk Werkgeversverbond — NCW (Netherlands)
Confederacion Espanola de Organizaciones Empresariales — CEOE (Spain)
Associaçao Industrial Portuguesa — AIP (Portugal)
Confederaçao da Industria Portuguesa — CIP (Portugal)
Confederation of British Industry — CBI (United Kingdom)
Vereinigung Osterreichischer Industrieler — VOI (Austria)
Confederation of Finnish Industries (Finland)
Finnish Employers' Confederation (Finland)
Federation of Icelandic Industries (Iceland)
Confederation of Icelandic Employers (Iceland)
Confederation of Norwegian Business and Industry (Norway)
Swedish Employers' Confederation (Sweden)
Federation of Swedish Industries (Sweden)

"Vorort" de l'Union Suisse du Commerce et de l'Industrie (Switzerland)
Union Centrale des Associations Patrocales Suisses (Switzerland)
Turkish Industrialists' and Businessmen's Association — TUSIAD (Turkey)
Turkish Confederation of Employer Associations — TISK (Turkey)
Employers & Industrialists Federation Cyprus (Cyprus)
Malta Federation of Industry — MFOI (Malta)
Associazione Nazionale dell'Industria Sammarinese (San Marino)

APPENDIX III

Letter From the European Community To The United States Government.

EL EMBAJADOR de ESPAÑ
WASHINGTON
June 30th, 1989

The Honorable
James A. Baker, III
Secretary of State
U.S. Department of State
Washington, D.C. 2520

Dear Sir:

The Member States of the European Community have noted that the United States Supreme Court is shortly to hear an appeal against the judgement of the Seventh Circuit Court of Appeals in Imperial Chemical Industries plc [sic] and Alcan Aluminium Limited v. California Franchise Tax Board.

The EC Member States consider this to be an appropriate opportunity to restate their opposition to the use of worldwide unitary tax by the State of California. They would urge the United States Government to confirm that, like the previous Administration they, too, are opposed to the use of worldwide unitary tax.

The views of the EC Member States on worldwide unitary tax are well known.* They consider that the imposition of this tax is inconsistent with the internationally accepted principles underlying the Tax Treaties and Friendship Treaties that individual Member States have entered into with the United States. Specifically, the use of the tax by the State of California:

*Demarche of the EC Member States submitted to the U.S. Department of State; 19 March, 1980; 30 October, 1981; 29 June 1982; 1 August, 1983; 23 September, 1983; 20 December, 1984, 8 August, 1985; 30 August, 1985.

i) contradicts the "arm's length" principal of allocating income of multi-national corporations between different national jurisdictions;

ii) may give rise to substantial double taxation;

iii) imposes a severe compliance burden by insisting on the restatement of accounts of different, but affiliated, corporations throughout the world even when they are not doing any business in California — accounts which were originally prepared to meet the specifications of the countries in which these corporations are resident;

iv) has perverse effects on the worldwide strategy of multi-national corporations (since, for example, a cost saving investment made in any country outside the U.S., can increase the tax liability in California, even if the California subsidiary is loss-making);

v) discriminates against companies doing business in California via subsidiaries, rather than through non-affiliated companies.

The EC Member States are strongly opposed to the attempt by California or any other State to impose taxation in income of foreign corporations arising outside the U.S.; to interfere with worldwide investment strategies, and to insist on burdensome compliance requirements on companies located outside the U.S.

EC Member States are aware that California has amended its legislation to allow multi-national companies to elect, on payment of a fee, to be taxed on a "water's edge", rather than worldwide unitary basis. However, since they are opposed to the use of worldwide unitary tax in principle, Member States cannot accept that it is right to insist on a fee as the price for electing to avoid worldwide unitary tax. Moreover, the process of making such an election involves substantial and unreasonable burdensome compliance costs.

The EC Member States, of course, support the case submitted by Imperial Chemical Industries and by Alcan Aluminum in the District Court and the Seventh Circuit Court of Appeal. They also very much endorse the *amicus* brief submitted by the U.S. in the District Court in ICI and Alcan v. California FTB. The EC Member States are aware that the issue currently before the Supreme Court is the question of the standing of the foreign parent companies to challenge the tax in the Federal courts, rather than the constitutionality of the tax itself. However, they believe the two issues to be inextricably interlinked. The EC Member States consider that worldwide unitary tax imposes an administrative and economic burden on foreign parent corporations and breaches the arm's length standard. Since the U.S. in its double taxation convention adheres to the internationally accepted arm's length principle, application of worldwide unitary tax by separate states of the U.S. prevents the U.S. from speaking with one voice when regulating commercial relations with foreign governments, and in the opinion of EC Member States is unconstitutional. The administrative and economic burden is imposed directly on foreign corporate parents and it is this constitutionally significant burden which creates standing for those foreign parents.

The Member States note and appreciate the U.S. Government's opposition to worldwide unitary tax. Given the importance of the present case before the Supreme Court, the Member States would urge the U.S. Government to reaffirm their commitment to the position taken by the previous Administration.

Sincerely,

/s/ Julian Santamaria

Julian Santamaria
Ambassador of Spain

No. 92-1384

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BRIEF OF THE CONFEDERATION OF BRITISH INDUSTRY AS AMICUS CURIAE IN SUPPORT OF THE PETITION FOR CERTIORARI

Pursuant to Rule 37 of the Rules of this Court, this brief is respectfully submitted in support of the Petition for a Writ of Certiorari by amicus curiae the Confederation of British Industry. The parties have consented to the filing of this brief, and their written consents have been filed with the Clerk of this Court.

INTEREST OF AMICUS CURIAE

The Confederation of British Industry ("CBI") is an independent, non-party, non-political body organized in the United Kingdom. Its members include industrial, commercial, and public sector companies; employer organization and trade associations that represent individual manufacturing industries; and commercial associations. The CBI represents more than 250,000 busi-

nesses which together employ about half of the British workforce. The CBI is the effective voice of business in Britain.

A number of the CBI's members do business in the United States or own subsidiary companies that do business in the United States. The CBI, on behalf of its members, has a substantial and direct interest in taxation of United Kingdom companies. California's use of worldwide combined reporting has a direct and adverse impact on those members of the CBI that operate in the United States and on their U.S. affiliates.

The CBI values highly the maintenance of free world trade and positive economic links between the United Kingdom and the United States. The CBI believes worldwide combined reporting to be fundamentally destructive of foreign investment in the United States and therefore of broader trade relationships between the United States and other countries. The CBI actively opposes the use of worldwide combined reporting and has sought to eliminate worldwide combined reporting's discriminatory taxation system as applied to U.K. corporate groups.

INTRODUCTION AND SUMMARY OF ARGUMENT

California's system for apportioning the income of a multinational business, worldwide combined reporting, is inconsistent and incompatible with the system found by this Court to be the accepted international standard, arm's length separate accounting. *Container Corp. of America v. Franchise Tax Bd.*, 463 U.S. 159, 184 (1983). The purpose of this accepted standard is to mitigate or eliminate the many problems which can arise when nations claim jurisdiction over the profits of international business for taxation. Without such a standard nations cannot properly protect their domiciliary enterprises or their own fiscs when such enterprises trade abroad. Double taxation, uncertainty of treatment and undue compliance costs may make such international businesses less competitive and hence less profitable. The United States as the largest international trader is the most exposed.

California's use of an incompatible system justifiably enrages other nations. Perpetuation of that system will remove all incentive for such nations to continue to use the accepted and consistent international standard in dealings with the United States. Conflict among nations undoubtedly will occur as countries adopt systems modified to suit themselves or retaliate against United States business.

The California Supreme Court, in upholding California's use of its aberrant system, ignored this Court's historic concern for and sensitivity to international conflicts such as these. The California Court of Appeal recognized that the added compliance burden imposed by worldwide combined reporting justified foreign protest — but still did not overturn the California method. This Court must not allow California to destroy decades of consistent United States effort. This Court must review this case.

ARGUMENT

The major trading nations of the world have adopted the arm's length method as the international standard to divide income among nations for tax purposes. This Court has found this method to be the internationally accepted method. *Container*, 463 U.S. at 184.

Under separate accounting, each legal entity is a separate taxpayer to whom taxing jurisdiction applies separately. A nation taxes a foreign entity only when the entity does business in the nation directly rather than through a subsidiary, and then taxes only the profits arising in that nation. Jurisdiction of a country to tax any particular legal entity does not imply jurisdiction to tax related entities. The aim of the arm's length approach is to ensure that profits of multinational enterprises are allocated in such a manner that each country is able to tax the profits (but no more and no less) actually earned in the country.

Separate entity treatment is not absolute. Nations customarily reserve the right to examine transactions between related entities (or branches) to determine whether the transactions were at "arm's length" (that is, comparable to transactions between unrelated entities). The theory is that income realized on transactions governed by the marketplace is true economic income. Where a transaction was not carried out on an "arm's length"

basis, tax administrators may reallocate income or deductions between the entities to reflect marketplace amounts. The fundamental purpose and reach of the arm's length standard, however, is to fairly determine the marketplace profits ascribable to the trade or business carried out by the foreign entity (or subsidiary) within the taxing jurisdiction.[1]

California's worldwide combined reporting, on the other hand, requires aggregation of the income and deductions of each entity which is a member of a "unitary group", whether or not the other members carry on operations directly in the taxing jurisdiction. Its reach is worldwide and encompasses entities and activities with no real connection to California. California determines its "proper" share of the aggregate income by formula. In making this allegedly "proper" division, formulary apportionment rejects the experience of the marketplace. Implicit in the unitary system is the unwarranted assumption that profit rates in different units of a corporate family, engaged in different activities and in different locations, are always the same.

As a marketplace-based system, the arm's length method takes into account differing economic conditions in different source nations that can create different rates of return on investments. Rates of return clearly do differ. For example, in developing countries, property and payroll costs may be very low relative to those in the United States, with correspondingly higher profits. Companies investing in these countries will often demand higher profits to reflect the risks of expropriation, currency exchange limitations, or other factors. Even among developed nations, differences in market conditions result from different economic conditions, different standards of living, different payroll and property costs, and different tax rates; as well as from other costs imposed on companies by governments including environmental regulation, currency exchange regulations, worker safety, welfare, administrative compliance, and a host of other variables.

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[1]The Internal Revenue Service's authority for this reallocation is found in Section 482 of the Internal Revenue Code (26 U.S.C. § 482). The United Kingdom grants the Inland Revenue similar power.

Double taxation is the one easily perceived result of incompatible systems.[2] Over many years the major trading nations, led by the United States, have adopted a single standard to eliminate or at least to mitigate double taxation between nations. The international network of bilateral income tax treaties — not just between the United States and its treaty partners but also between other nations[3] — defines the jurisdiction of nations to tax resident companies of other nations. The standard also is embodied in the internal laws of nations and in model treaties. Thus, the standard provides a framework for resolution of disputes and fosters cooperation rather than conflict.

However, treaties and other tax harmonization techniques are capable of resolving conflicts only when the two jurisdictions have generally similar rules for dividing income. When a jurisdiction uses worldwide combined reporting, it has no common ground for working out differences with separate accounting jurisdictions. Elimination of double taxation, at a minimum, would require complex adjustment to the apportionment factors to take into account the varying profitability in each jurisdiction. Such adjustments necessarily would differ from jurisdiction to jurisdiction and from industry to industry. Harmonization is not practically possible.

Business and trade suffer when enterprises are forced to comply with inconsistent systems. One advantage of the international

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[2]Because the two systems will assign different amounts of income to jurisdictions in which rates of return differ, double taxation undoubtedly will occur. The problem of double taxation is especially severe where the entity operating in the worldwide combined reporting jurisdiction incurs a loss. The arm's length method would permit the entity to report this loss for tax purposes. Under worldwide combined reporting, if the entity were part of an overall group which realized an aggregate profit, the worldwide combined reporting jurisdiction would allocate to itself some of that overall profit. Because the separate accounting jurisdictions in which the profits arose would also source to themselves 100 percent of the profits, the multinational enterprise would pay a double tax.

[3]In 1986, the United Kingdom had over 70 treaties, each using the arms' length standard.

standard is that it does not force a foreign enterprise to reconstruct its *worldwide* information gathering systems (and those of its affiliates) in order to comply with tax reporting requirements in the nations in which it does business. California's system forces a business to do exactly that, requiring recomputation of worldwide income in accordance with U.S. accounting principles rather than those applicable locally, conversion into U.S. dollars, and translation of records into English. The California Court of Appeal recognized that foreign businesses do not have information systems needed to comply and would not *create* such system but for the California method. Petitioner's Appendix D at D-9, Appendix B at B-25 to B-26.

Further, the purpose of an international standard is not only to eliminate disputes among nations as to how and what they will tax, but also to provide a framework of certainty to businesses making foreign investments. Because there are no precise guidelines for determining when California will deem related entities to constitute a unitary enterprise, an enterprise considering an investment in California cannot know whether it will be subject to worldwide combined reporting. Assuming that the enterprise is deemed unitary, its California tax liability will depend not solely upon its activities in California (or even in the United States), but also upon its rates of return in any other nations in which the "unitary" enterprise has operations. Such variables are incapable of accurate estimation, and severe distortions inevitably will result.

These compliance burdens and uncertainties make the enterprise substantially less likely to make the proposed investment.[4]

[4]This Court has held that a state tax violated the interstate commerce clause when it "foreclose[d] tax-neutral decisions." *Boston Stock Exch. v. State Tax Comm'n*, 429 U.S. 318, 331 (1977). Worldwide combined reporting does just that.

California's excursion into international tax has had predictable results. Nations have protested vociferously and have threatened retaliation. This Court anticipated this result in *Japan Line, Ltd. v. County of Los Angeles*, 441 U.S. 434, 450-51 (1979):

> If the State imposes an apportioned tax, international disputes over reconciling apportionment formulae may arise. If a novel state tax creates an asymmetry in the international tax structure, foreign nations disadvantaged by the levy may retaliate against American-owned instrumentalities present in their jurisdictions.

More recently, in *Kraft General Foods, Inc. v. Iowa Dep't of Revenue and Fin.*, 112 S.Ct. 2365, 2370 (1992), this Court reaffirmed that the protection granted foreign commerce was broader than that granted to interstate commerce, "in part because matters of concern to the entire Nation are implicated."

As this Court noted in both *Japan Line* and *Container*, there is no ultimate international arbiter who can reconcile disputes among nations over tax systems. 441 U.S. at 447; 463 U.S. at 192. The nations themselves, led by the United States, have adopted the international arm's length standard to avoid exactly this problem. They have substituted cooperation for conflict. California is not a nation; it cannot participate in the dialogue of nations. If allowed to stand, California's aberrant system will continue to act as an irritant until other nations retaliate, not just against California, but against the United States as a whole. Further, California's system runs counter to established United States foreign tax policy and threatens, by its extraterritorial reach, the comity of nations.

CONCLUSION

The California Supreme Court and the Court of Appeal on remand did not even make a pretense of taking into account the important national policies which the international standard represents. It requires an affirmative act of Congress, not the negative inference by inaction perceived by the California Court, to unravel over sixty years of international effort. That is the potential effect of the California Court's decision. This Court should grant the Petition For a Writ of Certiorari.

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No. 92-1384

IN THE
Supreme Court of the United States

OCTOBER TERM, 1992

BARCLAYS BANK PLC,
Petitioner,
v.

FRANCHISE TAX BOARD,
Respondent.

On Petition for Writ of Certiorari to the Supreme Court of California

---

BRIEF OF THE COMMITTEE ON STATE TAXATION AS *AMICUS CURIAE* IN SUPPORT OF PETITIONER

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On Petition for Writ of Certiorari to the Supreme Court of California

BRIEF OF THE COMMITTEE ON STATE TAXATION AS *AMICUS CURIAE* IN SUPPORT OF PETITIONER

INTRODUCTORY STATEMENT

This brief is submitted by the Committee on State Taxation as *amicus curiae* in support of the petitioner in the above captioned matter. Written consents of the petitioner and respondent have been obtained and filed with the Clerk of Court.

INTEREST OF *AMICUS CURIAE*

The Committee on State Taxation ("COST") is a nonprofit association, which was originally organized in 1969 as an advisory committee to the Council of State Chambers of Commerce. COST, which was separately incor-

porated January 1, 1992, has a membership of over 380 major multistate corporations, engaged in interstate and international business. COST's objective is to preserve and promote equitable and non-discriminatory state and local taxation of multijurisdictional business entities.

Virtually all COST member companies are engaged in business in the State of California, either directly or through subsidiary operations, and are subject to that State's corporate income tax. COST's membership includes a substantial number of corporations that are owned by non-U.S. corporations. A significant number of COST member corporations are engaged in business in jurisdictions outside the United States and would be subject to retaliatory actions by such jurisdictions should worldwide combined reporting be upheld. Therefore, COST has an interest in the instant case, in which the constitutionality of California's imposition of worldwide reporting on foreign parent unitary groups is at issue.[1]

SUMMARY OF ARGUMENT

The State of California's imposition of worldwide combined reporting has been the subject of Foreign Commerce Clause challenges for over twenty years. Although this reporting method, as applied to domestic parent groups, was upheld in *Container Corporation of America v. Franchise Tax Board*, 463 U.S. 159 (1983), this Court explicitly reserved the specific question at issue in this case, that is, whether worldwide combined reporting as imposed on a foreign parent unitary group violates the Foreign Commerce Clause. *Id.*, 463 U.S. at 189, fn. 26.

[1] Worldwide combined reporting, the method used by California to apportion the income of multinational corporations, and the arm's length/separate accounting method, which is used by the United States and its foreign trading partners to allocate such income, are explained by petitioner in its Petition for Writ of Certiorari, at pages 5-6.

Not only does this case raise the issue reserved by this Court in *Container*, but it also presents certain facts that the Court emphasized as missing in *Container*, thereby precluding a finding for the taxpayer in that case. Unlike *Container*, the tax at issue in the instant case falls on a foreign entity, 463 U.S. at 195, the Federal Government has filed *amicus* briefs during the litigation in the California courts expressing its opposition to worldwide combined reporting, 463 U.S. at 195-196, and this Court no longer has to guess at the risk of retaliation by foreign nations, 463 U.S. at 194, as the offense to our foreign trading partners has been clearly expressed by the United Kingdom's enactment of retaliatory legislation. Thus, ten years after *Container*, this Court is finally presented with a fully developed opportunity to answer the important constitutional issue left open in that case.

As California's Franchise Tax Board pointed out in its Petition for Review and Brief on the Merits in the California Supreme Court, *Barclays* is the "test case" with regard to foreign parent unitary groups. Petition at 2, n. 1; Brief at 5, n. 6. This case affects not only Barclays, but also the large number of other taxpayers waiting for a final determination by this Court on the issue of whether worldwide combined reporting as imposed on foreign parent unitary groups violates the Foreign Commerce Clause.[2]

Moreover, the decision of the California Supreme Court, holding that "governmental silence" evidences Federal approval of worldwide combined reporting (or any other state policy implicating foreign relations) sets a precedent that is contrary to this Court's Foreign Commerce Clause

[2] The number of affected taxpayers is so large that the Franchise Tax Board was compelled to issue FTB Notice 89-714 on November 17, 1989, outlining the procedure to be used by taxpayers to defer cases pending a decision of the Foreign Commerce Clause issue in *Barclays*. Pet. App. I.

jurisprudence as developed in *Japan Line, Ltd. v. County of Los Angeles*, 441 U.S. 434 (1979), *Container, supra*, *Wardair Canada v. Florida Department of Revenue*, 477 U.S. 1 (1986), and most recently affirmed in *Itel Containers International Corp v. Huddleston*, 61 U.S.L.W. 4173 (Feb. 23, 1993).

Because of the implications of the decision of the California Supreme Court for the Federal Government's ability to conduct foreign policy; the importance of the issue to the states and to a large number of taxpayers, as well as foreign governments; and the number of years this issue has been pending in litigation, this Court should grant the petitioner's petition for writ of certiorari.

ARGUMENT

I. CERTIORARI SHOULD BE GRANTED IN THIS CASE BECAUSE THE FEDERAL GOVERNMENT'S ABILITY TO FORMULATE FOREIGN TRADE POLICY IS IMPAIRED BY CALIFORNIA'S IMPOSITION OF WORLDWIDE COMBINED REPORTING ON FOREIGN PARENT UNITARY GROUPS

Article I, § 8, cl. 3 of the United States Constitution reserves to Congress the power to regulate commerce with foreign nations and among the states. This Clause, "by its own force created an area of trade free from interference by the States" and "even without implementing legislation by Congress is a limitation upon the power of the States." *Boston Stock Exchange v. State of Tax Commission*, 429 U.S. 318, 328 (1977). With regard to foreign commerce, the "constitutional prohibition against state taxation . . . is broader than the protection afforded to interstate commerce . . . because matters of concern to the entire Nation are implicated." *Kraft General Foods, Inc. v. Iowa Department of Revenue and Finance*, 112 S. Ct. 2365, 2370 (1992). Because foreign commerce is afforded broader protection, this Court stated in *Japan*

Line, Ltd. v. County of Los Angeles, 441 U.S. 434, 448 (1979), that "[f]oreign commerce is preeminently a matter of national concern" and held that a state tax violates the Foreign Commerce Clause if it "impair[s] federal uniformity in an area where federal uniformity is essential."

Last month in *Itel Containers International Corp v. Huddleston*, 61 U.S.L.W. 4173 (Feb. 23, 1993), this Court reaffirmed that when a state tax is being scrutinized under the Foreign Commerce Clause, the tax must be analyzed under the tests set forth in *Japan Line*, as well as the four-prong test set forth in *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274 (1977).[3] Quoting *Japan Line, supra* at 451, this Court stated in *Itel, supra* at 4176, that

> a court must also inquire, first, whether the tax, notwithstanding apportionment, creates a substantial risk of international multiple taxation, and second, whether the tax prevents the Federal Government from "speaking with one voice when regulating commercial relations with foreign governments."

In *Container Corporation of America v. Franchise Tax Board*, 463 U.S. 159 (1983), this Court elaborated on the "one voice" requirement of *Japan Line*, stating that where a state tax is at variance with federal policy, the "one voice" standard is violated if the state tax "*either* implicates foreign policy issues which must be left to the Federal Government *or* violates a clear federal directive." 463 U.S. at 194 (emphasis in original). In determining

[3] In *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274, 279 (1977), this Court set forth the following four-prong test for determining whether a state tax comports with the interstate commerce clause: 1) whether there is a substantial nexus between the state and the activity it seeks to tax; 2) whether the tax is fairly apportioned to the taxing state; 3) whether the tax discriminates against interstate commerce; and 4) whether the tax is fairly related to the services provided by the state.

whether the "one voice"* test is violated due to the implication of foreign policy, this Court stated that "[t]he most obvious foreign policy implication of a state tax is the threat it might pose of offending our foreign trading partners and leading them to retaliate against the Nation as a whole." *Id.*

In *Container,* this Court felt that it could not determine when a foreign nation might be offended by a state tax policy. However, it is now indisputable that foreign trading partners are offended by worldwide combined reporting and that retaliatory actions with national impact may be taken. In 1985, the United Kingdom enacted retaliatory legislation that would deny certain tax credits, provided by the United States/United Kingdom Income Tax Treaty,[4] to United States corporations doing business in a state imposing worldwide combined reporting. Finance Act of 1985, section 54, recodified as Section 812 of the Income and Corporation Taxes Act of 1988. Although the United Kingdom has not yet triggered this provision, "[t]he risk of retaliation . . . under these circumstances, is acute." *Japan Line, supra,* 441 U.S. at 450.

The risk of offending a foreign trading partner and prompting retaliatory action is all the more acute in the face of the decision of the California Supreme Court upholding the constitutionality of worldwide combined reporting as imposed upon a unitary group whose parent is a United Kingdom corporation.[5] As this Court stated

[4] Under the United States/United Kingdom Income Tax Treaty, a United States corporation receives a refund of certain amounts of taxes withheld by a United Kingdom payor on dividends paid by that payor. United States corporations are entitled to this refund for taxes paid on dividends received from U.K. subsidiaries and from investments of at least 10% in unrelated U.K. corporations.

[5] In *Unitary Tax: Review of Progress Towards Resolving the Problems,* a Joint Report by Inland Revenue and the U.S. Treasury, issued in December, 1991, the United Kingdom reviewers concluded

in *Japan Line,* "California, by its unilateral act, cannot be permitted to place these impediments before this Nation's conduct of its foreign relations and its foreign trade." 441 U.S. at 453.

Moreover, the retalitory action taken by the United Kingdom "of necessity would be felt by the Nation as a whole," *Japan Line, id.,* because the impact of its retaliatory statute is not limited to California based corporations. The statute denies the refund otherwise due a United States corporation under treaty if the U.S. corporation or one of its affiliates has a "qualifying presence" in California. Income and Corporations Taxes Act of 1988 ("1988 Act"), section 812(1). The United Kingdom may, at its discretion, consider a company to have such a "qualifying presence" within California if it is subject to tax by the State, 1988 Act, section 812 (7), or if the corporation has relatively small property, payroll or sales in California. 1988 Act, section 812(3). Therefore, a corporation doing business in every state except California and which receives dividends from investments in U.K. corporations could face a greatly increased U.K. tax burden if it is simply affiliated with a corporation with minimal contacts with California.

California's deviation from the internationally accepted allocation method also imposes enormous accounting and administrative burdens on taxpayers with affiliates in both California and foreign countries. Since the foreign corporations that are required to be included in a worldwide unitary group are not taxable in the United States and may not have any transactions with any U.S. entity, they have no reason to maintain books and records on a U.S.

that, *pending settlement of the issue of the constitutionality of worldwide combined reporting through litigation,* the United Kingdom "should maintain its retailatory legislation on the statute book, giving no further guarantees as to whether the legislation, if it were to be triggered, would be retrospective, but should not trigger it." ¶ 7.2.a.

basis or on a basis reflecting the State's three-factor (property, payroll and sales) formula. Thus, the use of the worldwide combined reporting system requires a totally separate record keeping system solely for California tax purposes.

The worldwide combined reporting method requires a foreign corporation to prepare and maintain records in United States currency. The required conversion of financial data of each foreign subsidiary to United States dollars must take into account many different exchange rates and sharp fluctuations of value. Such computations are a costly and burdensome administrative expense necessitated by California's deviation from international and federal tax standards. The costs of complying with the administrative requirements of California's tax system may, in fact, exceed any tax which is ultimately due the state.

The administrative compliance burden of worldwide combined reporting in the face of an otherwise uniform standard is prohibitive and creates the very barrier to international trade that the foreign commerce clause is intended to prevent. It also presents a formidable barrier to interstate commerce when a foreign-owned entity doing business in a non-worldwide combined reporting state, *e.g.*, Illinois, starts to do business in California. That entity, if related to any foreign entities through a foreign parent, would subject each company in the entire group to onerous record keeping requirements solely to satisfy California's tax return filing requirements.

Taxpayers have challenged California's use of worldwide combination on Foreign Commerce Clause grounds since the State began enforcing this form of taxation. The instant case involves the 1977 tax year and was pending during the *Container* litigation. Thus, ten years after that case and sixteen years after the tax year at issue, the Court finally has the opportunity to answer the

quesion it left open in *Container*. The California Franchise Tax Board recognizes that *Barclays* is the test case, and, therefore, the best vehicle for this Court to decide whether the imposition of worldwide combined reporting on foreign parent unitary groups violates the Foreign Commerce Clause. Franchise Tax Board Petition to the California Supreme Court at 2, n.1 and Brief on the Merits at 5, n.6; *see also*, Franchise Tax Board Notice No. 89-714, Pet. App. I. This Foreign Commerce Clause issue is of such importance to international trade and the retaliatory threat to domestic corporations so immediate that it must not be left unanswered by this Court any longer.

II. CERTIORARI SHOULD BE GRANTED IN THIS CASE BECAUSE THE DECISION OF THE CALIFORNIA SUPREME COURT IS CONTRARY TO THIS COURT'S FOREIGN COMMERCE CLAUSE JURISPRUDENCE

According to the decision of the California Supreme Court, Congressional ratification of worldwide combined reporting is evidenced by the fact that Congress has not, either in a committee or in the full House or Senate, voted on legislation preventing such a state tax on foreign commerce.[6] Misinterpreting *Wardair Canada v. Florida De-*

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[6] The California Supreme Court did rely heavily on the Senate's actions in ultimately ratify g the United States-United Kingdom income tax treaty without a prohibition of States' use of worldwide combined reporting. However, this was not an action that was taken by the entire Congress. Only the Senate gives its consent to foreign treaties. U.S. Constitution Art. II, § 2. This action cannot be imputed to the House or used as evidence of *Congressional* approval of California's use of worldwide combined reporting. There is no authority to support the California Supreme Court's use of the failure of two-thirds of the Senate to ratify a treaty containing a specific provision, pursuant to its powers under Article II of the Constitution, as evidence of the intent of the majority of the Congress to approve a state tax affecting foreign commerce pursuant to its authority under Article I of the Constitution. In fact, a

partment of Revenue, 477 U.S. 1 (1986), the California Supreme Court concluded that there is a "species of governmental *silence* that forecloses resort to a dormant foreign commerce clause analysis." *Barclays Bank International, Ltd. v. Franchise Tax Board*, 899 P.2d 279, 291 (Cal. 1992) (emphasis in original). However, this Court held in *Wardair* that it is just such governmental silence that triggers the dormant commerce clause analysis. The dormant commerce clause analysis was not applied by the Court in *Wardair* because the federal government was not silent, but had affirmatively acted by entering into international agreements explicitly limiting certain local tax powers. *Wardair, supra* at 9-10.

The California Supreme Court's misapplication of *Wardair* could be used to justify any state action affecting foreign commerce where Congress has not acted, effectively destroying the protections to foreign trade provided by the dormant Commerce Clause. This broader issue, as well as the specific issue with regard to worldwide combined reporting, requires review and clarification by this Court.

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majority of the Senate voted against a reservation deleting the provision prohibiting states from imposing worldwide combination. Joint Committee on Taxation, *State Taxation of Multinational Business* (JCX -27-86), September 29, 1986, p. 19.

CONCLUSION

For the reasons set forth above, the Committee on State Taxation respectfully requests that petitioner's petition for writ of certiorari be granted.

Respectfully submitted,

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Dated: April 23, 1993

No. 92-1384

IN THE

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OCTOBER TERM, 1993

BARCLAYS BANK PLC,

Petitioner,

v.

FRANCHISE TAX BOARD, AN AGENCY OF THE STATE OF CALIFORNIA,

Respondent.

On Petition for a Writ of Certiorari to the Court of Appeal of the State of California in and for the Third Appellate District

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MOTION OF THE GOVERNMENT OF THE UNITED KINGDOM FOR LEAVE TO FILE A SUPPLEMENTAL BRIEF AMICUS CURIAE AND ACCOMPANYING BRIEF IN SUPPORT OF PETITION FOR A WRIT OF CERTIORARI

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IN THE

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---

MOTION OF THE GOVERNMENT OF THE UNITED KINGDOM FOR LEAVE TO FILE A SUPPLEMENTAL BRIEF AMICUS CURIAE AND ACCOMPANYING BRIEF IN SUPPORT OF PETITION FOR A WRIT OF CERTIORARI

The Government of the United Kingdom respectfully moves this Court for leave to file a supplemental brief *amicus curiae* (attached hereto) in support of the petition for a writ of certiorari.

Significant international developments not discussed in the Brief for the United States as *Amicus Curiae* have occurred in the instant case since the filing of the petition for certiorari and the original supporting briefs *amicus*

curiae. On May 13, 1993, the British Government announced that it would have to take retaliatory measures against certain U.S. corporations if the matter of worldwide unitary taxation of foreign-owned companies was not satisfactorily resolved in California by the end of this year. That retaliatory action was deferred following California's legislative changes. However, it is important to note that the British Government has made clear that it will retaliate if it is found that the legislation is being applied in a way which exposes U.K.-owned companies to damage from taxation that is inconsistent with the arm's length principle.

The Government of the United Kingdom respectfully requests the opportunity to apprise this Court directly of the foreign policy implications of the developments that have occurred, and also to register the view that the unitary tax problem has not yet been completely resolved.

In that regard, the United States has suggested that California's legislative changes have produced an "accommodation of state, national and international interests" on the constitutional issue posed in the instant case. (Brief for United States as *Amicus Curiae*, p. 10.) Insofar as the Government of the United Kingdom is concerned, such an "accommodation" cannot be complete until the internationally accepted arm's length principle is endorsed, on a permanent basis, as the only valid method of taxing foreign companies in any State. At present, worldwide unitary taxation remains the basic method of taxation in California and exists, in some form, in at least six other states and could be imposed in any other. Contrary to the statement of the United States, therefore, the case continues to be of present and future relevance.

In addition, the Government of the United Kingdom is also concerned that, absent review by this Court, California will retain over $500 million already collected from (and another $400 million assessed against) foreign-owned corporations under a taxing scheme that this Court suggested in 1983 was constitutionally suspect.

The need for review by this Court arises because the lower courts in the instant case completely disagreed on the proper application of the "one voice" test. Indeed, the United States has concluded that the presently controlling decision of the California Supreme Court is "subject to serious question." (Brief for the United States as *Amicus Curiae*, p. 8.) Surely constitutional issues that so directly affect relations between nations warrant definitive resolution by this Court, not merely by lower state courts that cannot agree among themselves. Without such definitive resolution, there can be no complete solution for the future.

CONCLUSION

For the foregoing reasons, the Government of the United Kingdom respectfully requests that this Court grant its motion for leave to file a supplemental brief *amicus curiae* in support of the petition for a writ of certiorari.

Respectfully submitted,

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SUPPLEMENTAL BRIEF OF THE GOVERNMENT OF THE UNITED KINGDOM AS AMICUS CURIAE IN SUPPORT OF PETITION FOR A WRIT OF CERTIORARI

The Government of the United Kingdom, as *amicus curiae*, wishes to apprise this Court of the foreign policy implications of developments since the filing of the petition for a writ of certiorari.

On May 13, 1993, the then Chancellor of the Exchequer, Rt. Hon. Norman Lamont, M.P. announced that the Government of the United Kingdom would have to take retaliatory measures in relation to U.S.-based companies if a satisfactory solution to the problem of worldwide unitary taxation in California were not reached by December 31,

1993 (Appendix A). Following that announcement, the U.K. Board of Inland Revenue notified 900 major U.S. corporations with U.K. subsidiaries of the various retaliatory options available under the U.K. enabling legislation (Appendix B). Subsequently, the California Legislature enacted certain modifications to its taxing scheme, effective January 1, 1994. The new legislation did not, however, remove California's worldwide unitary tax as the basic method of taxation for foreign-owned groups (albeit with an election for an alternative). The Chancellor of the Exchequer, in a letter of September 14, 1993 to Secretary of the Treasury Bentsen stated that the United Kingdom would defer acting upon its threat of retaliatory action, rather than lifting it, pending satisfactory application of the California legislation. Consequently, in his public statement of September 15, 1993 (Appendix D), the Chancellor of the Exchequer stated that:

> [G]iven the defects that remain in the law, it will be important to ensure that the spirit of the new approach is followed in the detailed regulations and in the practical application of the law. The UK will therefore defer retaliatory action and will retaliate only if it is found that the legislation is being applied in a way which exposes UK owned companies to damage from taxation that is inconsistent with the arm's length principle.

In addition to the foregoing, on June 30, 1993, the Finance Committee of the German Bundestag requested that the German government consider what retaliatory steps might be taken if a satisfactory solution to the "problem of unitary taxation as applied in the State of California" has not been found by the end of 1993 (Appendix C). This request has not been rescinded.

Furthermore, on September 24, 1993—two weeks after passage of the California legislation—the Embassy of Belgium, on behalf of the Member States of the European

Community and the Delegation of the Commission of the European Communities, sent a Demarche to Secretary of State Christopher in which it was stated that, "[w]hile this legislation is an improvement, the Member States and the European Commission do not consider that the unitary tax problem is solved." (Appendix E.) On October 14, 1993, all the Member States of the EC in addition to the Governments of Australia, Austria, Canada, Finland, Japan, Norway, Sweden and Switzerland sent a Demarche to the Secretary of State affirming their opposition to "[w]orldwide unitary taxation, which is . . . disruptive of international economic relations." (Appendix F.)

The Government of the United Kingdom is unaware of any state taxing scheme that has ever given rise to the international concern that worldwide unitary taxation has. To the major trading partners of the United States, the continued use of such a taxing scheme, which results in the taxation by a state, as in the case of California, of profits earned entirely outside the U.S., is unacceptable for reasons previously set forth.

In *Container Corp.* v. *Franchise Tax Board*, 463 U.S. 159 (1983), this Court declared that a state tax would violate the "one voice" test set down in *Japan Line, Ltd.* v. *County of Los Angeles*, 441 U.S. 434 (1979), "if it *either* implicates foreign policy issues which must be left to the Federal Government *or* violates a clear federal directive." (*Container Corp.* at 194, emphasis in original.) This Court then went on to state that "The most obvious foreign policy implication of a state tax is the threat it might pose of offending our foreign trading partners and leading them to retaliate against the Nation as a whole." (*Id.* at 194, citing *Japan Line* at 450.)

The Government of the United Kingdom believes that the international developments described above could provide no clearer indication of the severe foreign policy implications of California's system of worldwide unitary tax.

These developments dramatically underscore the concern of the United States itself, so clearly expressed in its *amicus curiae* brief filed in August 1992 at an earlier stage of the instant case:

> California's application of its worldwide combined reporting method of taxation to compute the income tax of members of foreign-controlled unitary corporate groups violates the Commerce Clause under this Court's analysis in *Container Corp.* because California's unilateral action departs from an accepted international practice to which the United States adheres and prevents the United States from speaking with one voice on this sensitive and important matter of foreign commercial relations.

Brief of the United States as *Amicus Curiae* In Support of Petitioner, pp. 12-13, Docket No. 92-212.

The United Kingdom Government's position on retaliation, which is not fully reflected by the Franchise Tax Board in its supplemental brief to this Court, is as stated by the Chancellor on September 15, 1993:

> While the legislation in California is a significant step forward, on its own it does not provide a complete solution to the unitary tax problem. For a complete solution it will be necessary to have the internationally accepted arm's length principle endorsed, on a permanent basis, as the only valid method of taxing foreign companies in any State. Success for the Barclays case in the Supreme Court would achieve this. The Government will continue strongly to support Barclays' case. I hope it will succeed. If it does not, the UK will have to retain its retaliatory powers in reserve as a barrier against the possibility that States might damage UK owned companies by

> the imposition of unitary taxation at some time in the future.

In view of this, and so long as worldwide unitary taxation remains the basic method of taxation in California (albeit with an election for an alternative) and exists, in some form, in at least six other States and could be imposed in any other, the Government of the United Kingdom does not consider that there has been an "accommodation of state, national and international interests" regarding the issues presented in the instant case.[1]

The United Kingdom is seriously concerned that California could retain $900 million of taxes paid or owing by foreign-owned corporations under a taxing scheme validated only by a state court decision which the United States itself admits is "subject to serious question." (Brief for the United States as *Amicus Curiae*, p. 8.)

Important principles of Federal constitutional law, with extremely serious international implications, are at stake. In light of this Court's previously expressed concerns regarding the application of worldwide unitary taxation to foreign-owned companies, allowing inferior state courts to have the final say as to the constitutional validity of California's taxing scheme seems fundamentally unfair to the taxpayers involved.

At the very least, further clarification of the application of the Foreign Commerce Clause would seem to be called for where foreign policy issues are so directly implicated

[1] In its supplemental brief, the Franchise Tax Board refers to what were "apparently" the "three major concerns" of the United Kingdom and the European Economic Community with the 1986 California water's edge method (all of which concerns have been allayed, it then states, by the California legislation passed in September 1993). However, the position of the Government of the United Kingdom has always been that for a complete solution it would be necessary to have a permanent endorsement of the arm's length principle as the only valid method of taxing foreign companies in any State.

and lower state courts appear totally confused by this Court's prior pronouncements on the application of the "one voice" test.

CONCLUSION

For all of the foregoing reasons, the Government of the United Kingdom respectfully urges this Court to grant the petition for a writ of certiorari in the instant case.

Respectfully submitted,

JEROME B. LIBIN
(Counsel of Record)
WILLIAM H. MORRIS

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(202) 383-0100

Counsel for the Government of the United Kingdom

October 15, 1993

APPENDIX

APPENDICES

Appendix A

May 13, 1993, Statement of the Chancellor of the Exchequer, Rt. Hon. Norman Lamont, M.P.

US Treasury Secretary Bentsen has explained the US Administration's position. He and his colleagues recognize the importance the Government attaches to this issue, the strength of feeling in the UK and the risk of retaliatory action by the UK if a satisfactory solution is not forthcoming. He has assured me that the Administration are very keen to find a solution to this problem that is acceptable. I have said that the Government is ready to discuss how an acceptable solution could be best achieved. But I have informed him that the Government will have to take retaliatory measures in relation to United States based companies if there is not a satisfactory resolution of the problem of the internationally-opposed unitary tax on foreign-owned companies in California by the end of this year. Meanwhile, I have instructed the Inland Revenue to obtain information from California-based companies in the UK, on the probable impact of such retaliatory measures.

Appendix B

Letters from Ian Spence, Director International Division, Inland Revenue, dated June 3, 1993 and June 25, 1993, to U.S. corporations with U.K. subsidiaries and to U.K. subsidiaries of U.S. corporations, respectively.

Chief Executive Officer
[address]

3 June 1993

Dear Sir/Madam,

I am writing to you in connection with the issue of Unitary Taxation. As you may know the UK Government have announced that they will have to take retaliatory measures in relation to United States based companies if there is not a satisfactory resolution of the problem of the internationally opposed unitary tax on foreign owned companies in California by the end of the year. I enclose a copy of the press release issued on the day of the announcement, which reproduces the Chancellor's statement in full and gives some of the background.

While a number of possible retaliatory measures are being considered, the Government's instruction to this Department to obtain information is directed at the effects of implementing a measure which is already on the UK statute book. This provision, Section 812 of the Income and Corporation Taxes Act 1988, would deprive certain US corporations of their right to tax credits on dividends payable from UK subsidiaries. The extent to which US corporations would be affected would depend on which of the range of measures in the legislation was approved by Parliament. The Inland Revenue will be writing to UK companies that are, or may be, subsidiaries of US corporations to obtain detailed information. But as a preliminary step I am writing to US corporations which appear to have subsidiaries in the United Kingdom. My purpose in doing so is to outline the effects of the legislation so that US

parent corporations can consider whether they would be affected by the legislation and if so to what extent. If you consider that your corporation would not be affected by the legislation and you wish to inform my Department direct, that will avoid needless correspondence. If you think that your corporation would, or might, be affected, you may wish to write to me direct or you may wish to give the information to your UK subsidiary so that it can reply to the enquiries it will be receiving.

To assist you in assessing the possible impact of §812 on your corporation it might help if I gave a brief description of its provisions.

This legislation was passed in 1985. It would withdraw the right to tax credits payable to a US Corporation that, either alone or together with its associates, controls at least 10% of a United Kingdom company. In its current form §812 denies tax credits that would normally be payable to US corporations if they have a "qualifying presence in a unitary state". At present California would be a "unitary state" for this purpose. What amounts to a "qualifying presence" can be defined in three different ways under the legislation. A corporation has a qualifying presence in a unitary state if it, or a corporation with which it is associated:

- has its principal place of business is in a unitary state, and that place includes both the place where the central management and control is exercised and the place where the immediate day-to-day management is located, or
- is subject to tax on its income or profits in a unitary state, or
- has $7^1/_2$% or more in value of its US property, pay roll or sales attributable to or derived from a unitary state.

The Treasury Order that would bring §812 into force would specify which definition was to apply. A corporation is

associated with another corporation at a given time if, at that time or at any other time within six years previously, one of the two has control of the other, or both are under the control of the same person or persons (Sections 812(5)(d) & 416(1) Income and Corporation Taxes Act 1988).

The legislation also allows for the provisions to be applied retrospectively. In March 1989 the UK Government stated that the legislation could be applied to dividends paid after 31 December 1989. In that case the tax credit would have to be repaid and the recipient corporation would become liable to a fine equal to twice the amount of the original credit. In addition interest would be charged at the rate of 9% per annum.

I hope that this letter has been helpful in explaining the provisions of §812. I also hope that it will enable you to assess whether or not §812 would affect your corporation if it were implemented, and if so to what extent. As I said earlier in this letter, the Inland Revenue will be writing to UK subsidiaries of US corporations for the information which we have been asked to obtain. But if you would like to write to this Department direct as suggested above, or would like further information, please contact Suzanne Wallace, Room G17, Strand Bridge House, 138-142 Strand, London, WC2R 1HH, telephone 44 71 438 6118, fax 44 71 438 6865.

Yours faithfully,

IR SPENCE

Finance Director
[address]

25 June 1993

Dear Sir/Madam,

UNITARY TAXATION AND UNITED KINGDOM DIVIDENDS

As you may know, the UK Government announced in May that they will have to take retaliatory measures if there is not a satisfactory resolution of the problem of the internationally opposed unitary tax on foreign owned companies in California by the end of the year. This could affect your company. I enclose a copy of the press release issued on the day of the announcement, which reproduces the Chancellor's statement in full and gives some of the background.

While a number of possible retaliatory measures are being considered, the Government has instructed the Inland Revenue to obtain information about the effects of implementing a measure which is already on the UK statute book. Retaliatory legislation was enacted in 1985 and is now Sections 812 to 815 of the Income and Corporation Taxes Act 1988. As yet, it has not been put into effect. I would like to explain how your company may be affected and to ask you for specific information about your company and the companies with which it is associated. I have already written to your parent corporation in the United States advising it that I am making this approach.

If Section 812 were to come into force, it would withdraw the right to tax credits payable to a US corporation that, either alone or together with its associates, controls at least 10% of a UK company. In its current form, Section 812 denies tax credits that would normally be payable to US corporations if they have a "qualifying presence in a unitary state". At present California would be a "unitary

state' for this purpose. What amounts to a "qualifying presence" can be defined in three different ways under the legislation. A corporation has a qualifying presence in a unitary state if it, or a corporation with which it is associated:

- has its principal place of business in a unitary state, and that place may be either the place where the central management and control is exercised or the place where the immediate day-to-day management is located, *or*
- is subject to tax on its income or profits in a unitary state, *or*
- has $7\frac{1}{2}\%$ or more in value of its US property, payroll or sales attributable to or derived from a unitary state.

The Treasury Order bringing Section 812 into force would specify which definition was to apply.

It seems that dividends paid by your company would fall within the provisions of Section 812, as currently drafted. From our records it appears that at least 10% of your company is controlled by a US Corporation(s) that has, or is associated with a Corporation(s) that has, a qualifying presence in California under at least one of the definitions set out in Section 812. In the annex to this letter I set out the information that the Inland Revenue needs to check whether this assumption is correct. In the absence of information to the contrary, Section 812, if it came into effect, would oblige us to assume that dividends paid by your company would not be entitled to attract UK tax credits.

The legislation also allows for the provisions to be applied retrospectively. In March 1989 the UK Government stated that the legislation could be applied to dividends paid after 31 December 1989. In that case, the tax credit would have to be repaid and the recipient corporation would also become liable to a fine equal to twice the amount of the original credit. In addition interest would be charged at

the rate of 9% per annum from the date when the original credit was paid. If the tax credits and the fine are not paid by the original recipient, Section 813(6) allows recovery to be made from connected persons. Clearly this would include your company. Furthermore, the ability of your company to set-off payments of advance corporation tax against its liability to corporation tax, or that of a subsidiary, may be limited under Section 813(6)(b).

I should also mention that there are provisions that are designed to prevent the avoidance of Section 812. Section 814 addresses arrangements for transferring profits in a form other than the payment of a dividend. It is widely drafted and payments caught by its provisions would not be allowable for UK tax purposes. Section 815 gives the Board of Inland Revenue powers to inspect documents in order to check whether the provisions of Sections 812 to 814 apply to the foreign parent of a UK company or any company associated with it.

I hope you have found this letter helpful as an explanation of Sections 812 to 815 and that it will help you when providing the information asked for in the attached annex. Finally, I should say that the Government has expressed the hope that action will be taken in the United States, before the end of the year, to resolve the problem of unitary taxation.

Yours faithfully,

IR SPENCE

ANNEX—A REQUEST FOR INFORMATION

1. Please provide the full names and addresses of any person who has been a shareholder in your company since 31 December 1989. For each such shareholder please state:

a. The number and type of shares held by that person on 1 January 1990 or at the time that the shareholder first acquired shares in your company if that is later.

b. Any changes in the number or type of shares held by that person since 1 January 1990 or the date on which the shareholder first acquired shares in your company if that is later.

c. If the shareholder is a body corporate the place of incorporation.

2. Please detail the dividend payments, of whatever kind, made to each shareholder since 31 December 1989, stating:

a. The date on which each dividend was paid.

b. The amount of dividend paid to each shareholder listed in the reply to question 1 that is a United States corporation and which either alone or together with one or more associated corporations, at the time the dividend was paid, controlled, directly or indirectly, at least 10 per cent of the voting stock of your company.

c. The amount paid by your company in respect of a shareholder's entitlement under a double taxation agreement to payment of the excess of the tax credit relating to that dividend over its liability to income tax, and the date on which such amounts were paid.

3. For any shareholder listed in reply to question 1 that is a body corporate:

a. Please state all the names and addresses of any other bodies corporate with which it has been associated since 31 December 1989, wherever incorporated.

b. Detail at what times since 31 December 1989 they have been so associated and the places of incorporation of the associated bodies corporate.

A corporation is associated with another corporation at a given time if, at that time or at any other time within six years previously, one of the two has control of the other, or both are under the control of the same person or persons (Sections 812(5)(d) & 416(1) Income and Corporation Taxes Act 1988).

4. For each shareholder listed in reply to question 1 which is a United States corporation, and for each other body corporate which is associated with such a United States corporation, wherever incorporated:

a. Please state if it is, or has been at any time since 31 December 1989, a member of a group and if the answer is "yes" please also:

b. State the full names, addresses and place of incorporation of the other members of the group on 1 January 1990, or at the time the body corporate in question joined the group if later.

c. List all subsequent changes to the membership of the group, including changes of names, or addresses of any members of the group.

d. List the periods, ending after 31 December 1989, that the members of the group of which the corporation is a part made up their accounts. Please provide copies of the group accounts for each such period. Copies of group structure charts for these periods should also be submitted.

e. State if the proportions, by value, of the group's property, payroll or sales situated in, attributable to, or derived from the State of California equalled or exceeded $7\frac{1}{2}\%$ of its total US property, payroll or sales, in any period, ending after 31 December 1989, for which the

members of the group made up their accounts. If so, please set out when this was so.

f. State the current proportion, by value (defined below), of the group's property, payroll and sales situated in, attributable to, or derived from the State of California as a percentage, in each case, of its total US property, payroll or sales.

For the purposes of Section 812 Income and Corporation Taxes Act 1988 "group" and "member of a group" are to be construed in accordance with Section 272(1) Income and Corporation Taxes Act 1970, now Section 170(2) et seq., Taxation of Chargeable Gains Act 1992, except that "51%" is to be substituted for "75%" and references to "a company" is not limited to a company incorporated under the laws of the United Kingdom or resident here.

The value of the property, payroll or sales of a company is the value as shown in its accounts for the period in question. For this purpose the value of any property consisting of an interest in another member of the group or of any sales made to another such member shall be disregarded (Section 812(4)(b)).

5. For any shareholder that is a United States corporation, and for any other body corporate that is associated with such a United States corporation please state, for periods since 31 December 1989 during which the body corporate was a shareholder or associated with a shareholder, in which State the central management and control of the corporation was exercised and, if different, where the immediate day-to-day management of its affairs was conducted.

6. For any shareholder that is a United States corporation, and for any other body corporate that is associated with such a United States corporation, please state, for periods since 31 December 1989 during which the body corporate was a shareholder or associated with a shareholder, if the

corporation was liable to Californian State taxes in respect of its income or profits. If the corporation has been so liable, please explain on what basis, for what periods and to what tax.

Appendix C

June 30, 1993, Resolution of the Finance Committee of the German Bundestag concerning unitary taxation in the State of California.

The Finance Committee of the German Bundestag has today discussed the problem of unitary taxation as applied in the State of California to the cross-border apportionment of profits between associated enterprises.

The Finance Committee notes that this method of taxation used by the State of California is based on a flat-rate allocation of profits that is inconsistent with the internationally accepted arm's-length principle, that such allocation of profits can result in substantial double taxation and that it imposes disproportionate burdens on enterprises in discharging their tax filing obligations. In the opinion of the Committee, a "water's-edge" rule under which enterprises operating on an international basis can gain exemption from worldwide unitary taxation of their income only on payment of a large fee is also in conflict with the principles of taxation as agreed in the German-American Convention for the Avoidance of Double Taxation.

The Finance Committee notes with regret the departure of the new U.S. administration from the course followed by former U.S. administrations for more than 20 years. The rejection of unitary taxation has always been and still is both a reflection of mutually agreed positions and a necessary means of ensuring, among other things, that economic relations between the United States of America and the Federal Republic of Germany continue to function smoothly and without disruption.

The Finance Committee calls upon the new U.S. administration to return to the common approach adopted by all other OECD countries and to urge the State of California to relinquish, in the interest of avoiding disruptions of

international trade, the system of unitary taxation that is rejected by all other industrialized nations.

The Finance Committee requests the German government to take immediate steps to consider the application of retaliatory measures should it prove impossible to achieve a satisfactory solution to the problem of unitary taxation within a reasonable period of time. In making this request, the Finance Committee proceeds on the assumption that it will be possible to reach a satisfactory solution by the end of 1993.

Appendix D

September 15, 1993, Statement of the Chancellor of the Exchequer, Rt. Hon. Kenneth Clarke, Q.C., M.P.

I am greatly encouraged to learn that California has passed legislation to modify its unitary tax law. This development is a vindication of the Government's decision to set a definite time limit for the implementation of retaliatory measures. But for the Government's action it is clear that there would have been no progress in California. The approach that California has now adopted has been designed to bring to an end the problem of unitary tax for UK owned companies in California. However, given the defects that remain in the law, it will be important to ensure that the spirit of the new approach is followed in the detailed regulations and in the practical application of the law. The UK will therefore defer retaliatory action and will retaliate only if it is found that the legislation is being applied in a way which exposes UK owned companies to damage from taxation that is inconsistent with the arm's length principle. I am informing Secretary Bentsen accordingly.

While the legislation in California is a significant step forward, on its own it does not provide a complete solution to the unitary tax problem. For a complete solution it will be necessary to have the internationally accepted arm's length principle endorsed, on a permanent basis, as the only valid method of taxing foreign companies in any State. Success for the Barclays' case in the Supreme Court would achieve this. The Government will continue strongly to support Barclays' case. I hope it will succeed. If it does not, the UK will have to retain its retaliatory powers in reserve as a barrier against the possibility that States might damage UK owned companies by the imposition of unitary taxation at some time in the future.

Appendix E

Demarche on Unitary Taxation, September 24, 1993, from the Embassy of Belgium, Presidency of the European Community, on behalf of the Member States of the European Community, and from the Delegation of the Commission of the European Communities.

EMBASSY OF BELGIUM
WASHINGTON, D.C.

The Honorable
Warren Christopher
Secretary of State
Washington, D.C. 20520

Dear Mr. Secretary,

We have the honor to convey to you the attached note on unitary taxation on behalf of the Governments of the Member States of the European Community and the Commission of the European Communities.

We avail ourselves of this opportunity to renew to you the assurances of our highest consideration.

s/ Juan Cassiers	s/ Andreas van Agt
Ambassador of Belgium	Ambassador of the
EC-Presidency	Delegation of the Commission
	of the European Communities

UNITARY TAXATION

1. The Member States of the European Community and the European Commission have the honour to refer to their note of 26 March 1993 in which they expressed their strong opposition to worldwide unitary taxation and urged the United States Government to support the Barclays petition for certiorari to the United States Supreme Court. The Member States, together with eight other major trading partners of the United States, subsequently supported the Barclays Petition in an amicus curiae brief dated 22 April 1993.

2. The Member States and the European Commission note that the State of California has since passed legislation to modify its unitary tax law. While this legislation is an improvement, the Member States and the European Commission do not consider that the unitary tax problem is solved. Worldwide unitary taxation, which is contrary to the internationally agreed arm's length principle, is still the basis of the tax system in California. A complete solution will require the arm's length principle to be established as the only legitimate basis of taxing foreign companies in any state.

3.The Member States and the European Commission therefore continue strongly to urge the United States Government to support the Barclays petition for certiorari to the United States Supreme Court.

Appendix F

Demarche on Unitary Taxation, October 14, 1993, from the British Embassy on behalf of the Member States of the European Community and the governments of Australia, Austria, Canada, Finland, Japan, Norway, Switzerland and Sweden.

BRITISH EMBASSY
WASHINGTON, D.C.

The Honorable
Warren M. Christopher
Secretary of State
Department of State
7th Floor
Main State Department Building
2201 C Street, N.W.
Washington, D.C. 20520

Dear Mr. Secretary,

With the agreement of the other countries concerned, I have been asked to convey to you the attached note on unitary taxation on behalf of the governments of the member states of the European Community, and of Austria, Australia, Canada, Finland, Japan, Norway, Sweden and Switzerland.

Yours sincerely,

s/ Robin Renwick

UNITARY TAXATION

The 12 Member States of the European Communities: Belgium, Denmark, France, Federal Republic of Germany, Greece, Ireland, Italy, Luxembourg, the Netherlands, Portugal, Spain and United Kingdom; and the governments of Australia, Austria, Canada, Finland, Japan, Norway, Sweden and Switzerland ("the 20 countries") have the honour to refer to their brief for the Supreme Court of the United States in the case Barclays Bank plc v. Franchise Tax Board, dated 22 April 1993.

The countries concerned note that, since that date, the State of California has passed legislation to modify its unitary tax law. While this legislation is an improvement, the countries concerned do not consider that the unitary tax problem is finally resolved. Worldwide unitary taxation is contrary to the internationally agreed arm's length principle embodied in the bilateral tax treaties of the United States and disruptive of international economic relations. A complete solution would require the arm's length principle to be established as the only legitimate basis of taxing foreign companies in any state.

The 20 countries regret therefore that, in his brief filed on 7 October 1993, the Solicitor General of the United States does not support the Barclays petition for a writ of certiorari.

MOTION FILED

OCT 21 1993

No. 92-1384

IN THE

Supreme Court of the United States

OCTOBER TERM, 1993

BARCLAYS BANK PLC,
Petitioner,

v.

FRANCHISE TAX BOARD OF CALIFORNIA,
Respondent.

On Petition for a Writ of Certiorari to the Court of Appeal of the State of California in and for the Third Appellate District

---

MOTION FOR LEAVE TO SUPPLEMENT BRIEFS *AMICI CURIAE* AND SUPPLEMENT TO BRIEFS FOR COMMITTEE ON STATE TAXATION, ORGANIZATION FOR INTERNATIONAL INVESTMENT INC., AND UNION OF INDUSTRIAL AND EMPLOYERS' CONFEDERATIONS OF EUROPE AS *AMICI CURIAE* IN SUPPORT OF PETITIONER

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IN THE

Supreme Court of the United States

OCTOBER TERM, 1993

No. 92-1384

BARCLAYS BANK PLC,
Petitioner,

v.

FRANCHISE TAX BOARD OF CALIFORNIA,
Respondent.

On Petition for a Writ of Certiorari to the Court of Appeal of the State of California in and for the Third Appellate District

---

MOTION FOR LEAVE TO SUPPLEMENT BRIEFS *AMICI CURIAE*

The Committee on State Taxation, the Organization for International Investment Inc., and the Union of Industrial and Employers' Confederations of Europe (collectively "*amici*") hereby respectfully move for leave to file the attached supplement to their briefs *amicus curiae* in this case.

The interest of COST and its 400-plus multinational corporate members in this case has been described in its brief *amicus curiae*, filed with this Court on April 23, 1993. Likewise, the interest in this case of the Organization for International Investment Inc., an association the members of which are United States subsidiaries of foreign shareholders, and the Union of Industrial and Employers' Confederations of Europe, the official representative of European business and industry vis-a-vis the European Economic Community and other European institutions, has been described in their joint brief *amici curiae*, filed with this Court on April 23, 1993. The purpose of this supplement is to address events that occurred

after the due date for filing *amicus* briefs, and the effect that the Solicitor General says those events have on the issue in this case.

A full exposition of the completely developed controversy and of potential ramifications of this case by each interested and eligible *amicus* is ultimately to the benefit of the Court in its administration of certiorari. The Solicitor General, even while admitting that "the analysis and holdings of the California Supreme Court are subject to serious question," *Am.* U.S. Br. No. 92-1384, suggests that the new legislation renders this case moot. Your *amici* would like the opportunity to explain to the Court why recent California legislation does not render this issue moot for years prior to or after the effective date of the legislation.

Respectfully submitted,

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SUPPLEMENT TO THE BRIEFS FOR COMMITTEE ON STATE TAXATION, ORGANIZATION FOR INTERNATIONAL INVESTMENT INC., AND UNION OF INDUSTRIAL AND EMPLOYERS' CONFEDERATIONS OF EUROPE AS *AMICI CURIAE* IN SUPPORT OF PETITIONER

SUPPLEMENT TO ARGUMENT

I. THE ISSUE RAISED IN *BARCLAYS* IS *NOT* RESOLVED BY THE RECENT ENACTMENT OF "WATER'S EDGE" LEGISLATION IN CALIFORNIA

California's enactment of "water's edge" legislation [1] does not resolve the issue in this case, and should not constitute grounds for a refusal by this Court to review this case.

[1] S. B. 671 (1993), is effective for tax years beginning on or after January 1, 1994. The legislation is designed to make water's edge reporting an elective method available to the taxpayer.

First, California has not abandoned worldwide combination on an ongoing basis. Barclays itself has at least 17 taxable years either currently under audit or subject to audit, which pre-date the 1994 effective date of S.B. 671. Likewise, COST's member companies that are California taxpayers are subject to the continuing mandatory use of worldwide combination, with respect to pre-January 1, 1994 tax years. Audits and assessments against those open years will continue through the turn of the century. Moreover, the new water's edge legislation will not comport with Foreign Commerce Clause principles. For example, Canadian and Mexican and "80/20" subsidiaries are brought into a water's edge corporate group for reporting purposes, a practice that like worldwide combination violates the Foreign Commerce Clause. Therefore, in a very real sense, this issue remains viable.

Second, the question whether the worldwide combined reporting method violates the Foreign Commerce Clause continues to have significance beyond the borders of California. As long as worldwide combination is utilized by other states in addition to California, the question whether this method is unconstitutional cannot be considered "moot." Alaska, Idaho, Montana, North Dakota and Utah each use worldwide combination.

Third, the Solicitor General understates the issue when he states merely that worldwide combination is "subject to serious question." When the United States was a real party in interest in the case of *United States v. State of Alaska and Malone*, No. A87-328CIV (D. Alaska, filed July 15, 1987), it was much more candid. As stated in the Government's Memorandum of Points and Authorities in Support of Its Motion for Partial Summary Judgment, p. 10:

> The Alaska tax scheme is no different from the California tax system challenged in the *Barclays* case. The Alaska tax cannot be constitutionally applied to the foreign parent . . . of the domestic subsidiary . . . because the tax impermissibly interferes with the conduct of foreign affairs by the Federal Executive, taxation on a worldwide unitary basis has caused conflicts between the United States and foreign nations and led to the adoption of retaliatory legislation, and the tax contravenes established federal policy.

Respectfully submitted,

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No. 92-1384

In the Supreme Court
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BARCLAYS BANK PLC,
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vs.

FRANCHISE TAX BOARD,
AN AGENCY OF THE STATE OF CALIFORNIA,
Respondent.

On Writ of Certiorari to the Court of Appeal of the State of California in and for the Third Appellate District

JOINT APPENDIX — VOLUME I

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Petition for Certiorari Filed February 22, 1993
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The following opinions and orders have been omitted in printing this joint appendix because they appear on the following pages in the Appendix to the printed Petition For A Writ Of Certiorari:

CHRONOLOGICAL LISTING OF RELEVANT DOCKET ENTRIES

November 26, 1984	Complaint for Refund of Taxes filed by Barclays Bank International, Ltd. File No. 325059.
November 26, 1984	Complaint For Refund of Taxes filed by Barclays Bank of California. File No. 325061.
December 24, 1984	Answer to Complaint in File No. 325059.
December 24, 1984	Answer to Complaint in File No. 325061.
February 1, 1985	Stipulation and Order Re Filing of First Amended Answer to Complaint in File No. 325061.
February 1, 1985	First Amended Answer to Complaint in File No. 325061.
February 13, 1985	Order of Trial Court Consolidating the Separate Actions.
April 30, 1986	Request to File An Amicus Curiae Brief by the Government of the United Kingdom.
August 12, 1986	Motion of the United States of America For Leave to Participate as an Amicus Curiae.
August 26, 1986	Memorandum of Points and Authorities of the United Kingdom in Support of Its Motion to File an Amicus Curiae Brief.
September 12, 1986	Order Allowing Filing of an Amicus Curiae Brief by the Government of United Kingdom.
September 15, 1986	Order Allowing Filing of an Amicus Curiae Brief by the United States.
November 10, 1986	Trial Commenced.
December 15, 1986	First Amended Complaint For Refund of Taxes.
February 9, 1987	Plaintiffs' Opening Post Trial Brief.

April 6, 1987	Defendant's Post Trial Brief.
April 30, 1987	Plaintiffs' Post Trial Reply Brief.
June 16, 1987	Trial Court's Intended Decision.
July 17, 1987	Oder Correcting Clerical Errors in Intended Decision.
August 20, 1987	Statement of Decision — Trial Court Judgment in favor of Plaintiffs in both consolidated actions.
October 16, 1987	Notice of Appeal by Defendant Franchise Tax Board in both consolidated actions to the California Court of Appeal in and for the Third Appellate District.
November 16, 1987	Court of Appeal Order to Consolidate Appeals in Barclays Bank International Ltd. v. Franchise Tax Board (Civ. No. C003388) and Barclays Bank of California v. Franchise Tax Board (Civ. No. C003389).
June 10, 1988	Appellant's Opening Brief.
June 17, 1988	Brief of Amicus Curiae Thorn-EMI PLC and EMI Limited in Support of Plaintiffs and Respondents, Barclays Bank International Ltd. and Barclays Bank of California.
August 31, 1988	Brief of Amicus Curiae the Government of Canada in Support of Plaintiffs and Respondents.
August 31, 1988	Brief of Amicus Curiae the Government of the United Kingdom in Support of Plaintiffs and Respondents.
September 9, 1988	Brief of Amicus Curiae the United States in Support of Plaintiffs and Respondents.
September 22, 1988	Respondents' Brief.
December 9, 1988	Appellant's Reply Brief.

October 18, 1990	Respondents' Application to Share Oral Argument with Amicus Curiae the United States.
October 22, 1990	Order granting Respondents' Request for Additional Oral Argument and to Share Time With Amicus Curiae the United States.
November 20, 1990	Oral hearing in Court of Appeal.
November 30, 1990	Decision of Court of Appeal Affirming Judgment of the Trial Court in favor of Respondents.
December 14, 1990	Appellant Franchise Tax Board's Petition for Rehearing to Court of Appeal.
December 24, 1990	Respondents' Answer to Petition for Rehearing.
January 8, 1991	Franchise Tax Board's Petition for Review in California Supreme Court. Dkt No. S019064.
January 29, 1991	Answer to Petition for Review.
February 8, 1991	Reply to Answer to Petition for Review.
February 28, 1991	Order of California Supreme Court Granting Review.
April 1, 1991	Appellant Franchise Tax Board's Opening Brief on the Merits.
April 25, 1991	Brief of Amicus Curiae Multistate Tax Commission in Support of Appellant and Defendant.
May 1, 1991	Respondents' Barclays Bank International and Barclays Bank of California's Answer Brief on the Merits.
May 8, 1991	Brief of Amicus Curiae the Government of the United Kingdom in Support of Plaintiffs and Respondents.

May 14, 1991	Brief of Amici Curiae Banque Nationale de Paris and Bank of the West in Support of Plaintiffs and Respondents Barclays Bank International, Ltd. and Barclays Bank of California.
May 14, 1991	Brief of Amicus Curiae the Government of Canada in Support of Plaintiffs and Respondents.
May 14, 1991	Brief of Amicus Curiae the Committee on State Taxation of the Council of State Chambers of Commerce in Support of Plaintiffs and Respondents.
May 14, 1991	Brief of Amici Curiae the Member States of the European Communities and the Governments of Australia, Austria, Finland, Japan, Norway, Sweden and Switzerland in Support of Plaintiffs and Respondents.
May 15, 1991	Respondents' Brief in Reply to Amicus Curiae Multistate Tax Commission.
May 21, 1991	Brief of Amicus Curiae the United States in Support of Plaintiffs and Respondents.
June 4, 1991	Appellant Franchise Tax Board's Reply Brief on the Merits.
June 7, 1991	Brief of Amicus Curiae the Confederation of British Industry in Support of Plaintiffs and Respondents.
June 7, 1991	Brief of Amici Curiae the Organization for Fair Treatment of International Investment and the Union of Industrial and Employers' Confederations of Europe in Support of Plaintiffs and Respondents.

July 9, 1991	Appellant's Answer to Amicus Curiae Briefs of the United States, Banque de Paris and Bank of the West, Committee on State Taxation of the Council of State Chambers of Commerce, Government of the United Kingdom, Government of Canada, Member States of the European Communities and the Governments of Australia, Austria, Finland, Japan, Norway, Sweden and Switzerland, Confederation of British Industry, Organization for Fair Treatment of International Investment and Union of Industrial and Employers' Confederations of Europe.
March 25, 1992	Order of California Supreme Court Granting the Application of John J. McCarthy, Esq., for Leave to Appear as Counsel Pro Hac Vice and to Present Oral Argument on Behalf of the United States.
April 7, 1992	Oral Argument before the California Supreme Court.
May 11, 1992	Decision of the California Supreme Court Reversing the Judgment of the Court of Appeal and Remanding to the Court of Appeal for Further Proceedings.
August 3, 1992	Petition for a Writ of Certiorari in the United States Supreme Court filed by Barclays Bank PLC. Dkt No. 92-212.
August 27, 1992	Brief of Amici Curiae the Member States of the European Communities and the Governments of Australia, Austria, Canada, Finland, Japan, Norway, Sweden and Switzerland in Support of Petitioner Barclays Bank PLC.
August 27, 1992	Brief of Amicus Curiae the Government of the United Kingdom in Support of Petitioner.

August 28, 1992	Brief of Amici Curiae Nestle Holding, Inc. and Genstar Company in Support of Petitioner.
August 28, 1992	Brief of Amici Curiae Organization for International Investment Inc. and Union of Industrial and Employers' Confederations of Europe in Support of Petitioner.
August 31, 1992	Brief of Amicus Curiae the United States in Support of Petitioner.
September 1, 1992	Brief of Respondent Franchise Tax Board in Opposition to Petition For Writ of Certiorari.
September 1, 1992	Brief of Amicus Curiae the Institute of International Bankers in Support of Petitioner.
September 1, 1992	Brief of Amici Curiae National Foreign Trade Council, Inc., National Association of Manufacturers, Chamber of Commerce of the United States of America, United States Council for International Business, Emergency Committee for American Trade, American Petroleum Institute, Chemical Manufacturers Association, Financial Executives Institute, and California Chamber of Commerce in Support of Petitioner.
September 9, 1992	Appellant Franchise Tax Board's Supplemental Brief in California Court of Appeal on Remand.
September 10, 1992	Respondents' Barclays Bank International, Ltd. and Barclays Bank of California's Supplemental Letter Brief in California Court of Appeal on Remand.
October 5, 1992	Order of United States Supreme Court Denying Petition for Certiorari in Dkt No. 92-212.

November 20, 1992	Decision of the California Court of Appeal in and for the Third Appellate District on Remand, Reversing the Judgment of the Trial Court and Directing Entry of Judgment for Franchise Tax Board.
December 4, 1992	Franchise Tax Board's Request for Modification of Opinion on Remand.
December 7, 1992	Petition of Barclays Bank International Ltd. and Barclays Bank of California for Rehearing by Court of Appeal.
December 11, 1992	Franchise Tax Board's Answer to Petition for Rehearing.
December 18, 1992	Order of Court of Appeal Modifying Opinion on Remand and Denying Petition for Rehearing.
December 21, 1992	Barclays Bank International, Ltd. and Barclays Bank of California's Petition for Review in California Supreme Court. Dkt No. S019064.
January 8, 1993	Franchise Tax Board's Answer to Petition for Review.
January 12, 1993	Reply to Answer to Petition for Review.
January 18, 1993	Order of California Supreme Court Denying Review.
February 22, 1993	Petition of Barclays Bank PLC for Writ of Certiorari in United States Supreme Court. Dkt No. 92-1384.
May 17, 1993	Order of United States Supreme Court inviting Solicitor General to file a brief.
October 7, 1993	Brief of United States concluding that the petition should be denied.
November 1, 1993	Order of United States Supreme Court Granting Certiorari.

EXHIBIT 1

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SUPERIOR COURT OF THE STATE OF CALIFORNIA
COUNTY OF SACRAMENTO

BARCLAYS BANK INTERNATIONAL LTD.,
a corporation of the Country of England,
Plaintiff,
vs.
FRANCHISE TAX BOARD,
an agency of the State of California
Defendant.

BARCLAYS BANK OF CALIFORNIA
a California Corporation,
Plaintiff,
vs.
FRANCHISE TAX BOARD,
an agency of the State of California,
Defendant.

No. 32509 & No. 325061 (Consolidated for Purposes of Trial)

ENDORSED: November 3, 1986
JOYCE RUSSELL SMITH, CLERK
By Kathleen L. Burgess, Deputy

SCHEDULE I

JOINT STIPULATION OF FACTS
Trial Date 11-10-86

IT IS HEREBY STIPULATED by and between the parties, through their attorneys of record, that the following facts are agreed and undisputed. This stipulation shall not be construed as a concession by either party of the relevancy or materiality of any of the facts stipulated, and the parties reserve the right to argue the relevance, materiality or weight of any of the facts stipulated.

All documents referred to herein or specifically enumerated are compiled under separate cover, have been reviewed by counsel for the parties and their authenticity and foundational basis admitted. The documents shall be entered into evidence. Nothing contained in this stipulation shall prevent a party from introducing at trial any other or further evidence. With permission of Court, documents described in paragraphs 32, 40, and 41 hereof will be deemed admitted in evidence in entirety without physically presenting the same at trial. Either party may refer to said documents in summary form or as individual exhibits at trial or on appeal as evidence admitted at trial.

Nothing contained herein shall be construed as a waiver by any party of its right to review on appeal any question of law or fact arising in this action in the same manner and to the same extent as if the facts set forth herein had been proven in open court.

The parties will make any computations necessary for inclusion in appropriate findings after the court's decision in this matter.

This stipulation shall only apply to the above-entitled consolidated actions and to any appeals from the judgment of this Court.

FACTS

The following facts are agreed and undisputed:

1. During income year ending September 30, 1977 (hereafter referred to as income year 1977), plaintiff Barclays Bank International Limited ("BBI") was a corporation organized and existing

under the laws of England and was qualified to do, and was doing, business as a banking agency in San Francisco, California.

2. During income year 1977, BBI was engaged in general retail and commercial banking, leasing, and consumer and commercial finance, directly or through subsidiaries, in approximately fifty-five (55) countries and territories.

3. During income year 1977, BBI itself operated through banking agencies or branches in approximately thirty-three (33) nations or territories outside the United Kingdom. BBI operated in the United States through branches or agencies located in the states of Georgia, Massachusetts, Illinois, New York and California.

4. During income year 1977, BBI owned more than fifty percent (50%) of over seventy (70) subsidiaries which operated in approximately thirty-four (34) nations or territories outside the United Kingdom.

5. During income year 1977, BBI owned banking subsidiaries which were organized and operated in the United States, including Barclays Bank of New York ("BBNY") and Barclays Bank of California ("Barcal").

6. During income year 1977, BBI was a wholly-owned subsidiary of Barclays Bank Limited ("BBL"), a United Kingdom clearing bank, organized and existing under the laws of England.

7. During the income year 1977, BBL owned, directly or indirectly, in addition to BBI and its subsidiaries, over one hundred forty (140) subsidiaries, none of which was incorporated under the laws of the United States or any political subdivision or territory thereof, and none of which operated in California or in the United States.

8. During the income year 1977, BBL and all subsidiaries of which it owned more than fifty percent (50%) of the stock, directly or indirectly, including BBI and Barcal, operated in over sixty countries or territories. A list of these subsidiaries showing country of incorporation and equity ownership is attached as trial Exhibit 8. BBL and such subsidiaries will be referred to as the

Barclays Group and individually or collectively as a member or members of the Barclays Group, respectively.

9. During income year 1977, Barcal, a California banking corporation and a wholly-owned subsidiary of BBI, was engaged in the commercial banking business in the State of California where it operated through forty-nine (49) branch banking offices.

10. On January 1, 1985, pursuant to the United Kingdom's Companies Act and the Barclays Bank Act 1984, BBL was merged with BBI under the name Barclays Bank PLC, and a holding company, Barclays PLC, became the parent of Barclays Bank PLC.

11. Defendant Franchise Tax Board ("FTB") is an agency of the State of California. The FTB is vested with the power and duty to administer the Bank and Corporation Franchise Tax Law of the State of California.

12. For the income year 1977, BBI prepared and filed a California Bank and Financial Tax Return and paid a total tax liability to the Franchise Tax Board of $14,447.54.

13. For the income year 1977, Barcal prepared and filed a California Bank and Financial Tax Return and paid a total tax liability to the FTB of $541,276.49.

14. The FTB conducted an audit of the California tax returns of BBI and Barcal for the income year 1977. Upon audit the FTB determined that BBI and Barcal were part of a worldwide unitary business conducted by all members of the Barclays Group.

15. Based upon its determination that BBI and Barcal were a part of a worldwide unitary business conducted by all the members of the Barclays Group, the FTB issued Notices of Additional Tax Proposed to be Assessed (hereafter Notices) as follows: to BBI in the amount of $4,076.02 for a total tax for the income year of 1977 of $18,523.56; to Barcal in the amount of $254,699.45 for a total tax for the income year of 1977 of $795,975.94.

16. The FTB's calculation of BBI's and Barcal's California tax liability was set forth in Schedule 1 of the attachment to the Notices as follows:

BUSINESS INCOME:			
INCOME BEFORE TAXES, SECURITIES GAINS/LOSSES, MINORITY INTERESTS AND EXTRAORDINARY ITEMS ...	pg. 10 Pros.		£270,300,000
SECURITIES GAINS/LOSSES ..	pg. 30 Bbl A/R		(2,400,000)
EXTRAORDINARY ITEMS	pg. 23 Bbl A/R		300,000
TOTAL POUND STERLING			268,200,000
CONVERSION RATE			1.7025
BUSINESS INCOME — IN U.S. DOLLARS			$456,610,500
		BBI	Barcal
APPORTION TO CALIFORNIA		$149,083	$6,406,245
TAX RATE		.12425	.12425
TAX..................................		$ 18,524	$ 795,976
TAX PREVIOUSLY ASSESSED		$ 14,448	$ 541,276
ADDITIONAL TAX		$ 4,076	$ 254,700

17. The reference to "page 10 PROS" is a reference to page 10 of the Preliminary Prospectus dated March 31, 1981 $125,000,000 Barclays North American Capital Corporation % Guaranteed Capital Notes due 2006. The references to pages 30 and 23 respectively were references to the BBL Reports and Accounts for 1977. The reference to "TAX PREVIOUSLY ASSESSED" means the tax paid by BBI and Barcal on filing, net of certain refunds.

18. BBI and Barcal filed protests of the proposed assessments in 1982, which protests were timely. BBI had originally filed its tax returns for the income year 1977 on the basis that it was part of a unitary business composed of itself and its subsidiaries. BBI protested the tax on the basis, *inter alia*, that the correct method upon which to compute its tax liability was separate entity/arm's length accounting.

19. Barcal timely filed a protest of the proposed assessment. It had originally filed its tax returns for the income year 1977 on a

separate entity/arm's length accounting basis, and protested the additional assessment on the basis, *inter alia*, that the correct method upon which to compute its tax was separate entity/arm's length accounting.

20. On May 21, 1984, BBI paid the additional proposed tax of $4,076.02 and BBI's administrative protest was converted by operation of law into a claim for refund of taxes. It is upon this claim that the instant litigation is based.

21. On October 31, 1983, Barcal paid additional proposed tax of $250,000.00 and Barcal's protest was converted by operation of law into a claim for refund of taxes. It is upon this claim that the instant litigation is based.

22. After the issuance by the FTB of the Notices and the filing by BBI and Barcal of the protest, the FTB adjusted the audit schedules as follows:

BUSINESS INCOME PER AUDIT	£268,200,000
LESS: INCOME OF ASSOCIATED COMPANIES	(39,700,000)
ADD: DIVIDENDS FROM ASSOCIATED COMPANIES..............................	5,105,000
ANZ GROUP DIVIDEND	735,000
ADD: ACCOUNTING METHOD CHANGE (AMORTIZATION — FROM AGREEMENT PRIOR YRS)	1,429,000
ADD: EXTRAORDINARY INCOME, AMOUNT THAT HAD BEEN EXCLUDED (ATTRIBUTABLE TO MINORITY SHAREHOLDERS)	100,000
REVISED BUSINESS INCOME — POUND STERLING..................................	£235,869,000
CONVERSION RATE	1.7025
REVISED BUSINESS INCOME — U.S. $	$401,566,973
REVISED APPORTIONMENT % — BBI	.0003232
INCOME APPORTIONED TO CALIFORNIA	129,786
TAX RATE..................................	12.425%

TOTAL REVISED TAX		16,126
PREVIOUSLY ASSESSED		14,448
ADDITIONAL TAX — REVISED BBI	$	1,678
REVISED APPORTIONMENT % — BARCAL		.0139032
INCOME APPORTIONMENT TO CALIFORNIA		5,583,066
TAX RATE		12.425%
TOTAL REVISED TAX		693,696
PREVIOUSLY ASSESSED		541,276
ADDITIONAL TAX — REVISED BARCAL	$	152,420

23. Board issued Notices of Action on Taxpayer's Protest to BBI and Barcal on February 15, 1985, for the amounts set forth in paragraph 22.

24. The payment of $250,000.00 made by Barcal on October 31, 1983 was credited by the Board against Barcal's additional tax as revised of $152,419.01. The remaining amount was credited to the interest owing on such liability and on April 19, 1985 an additional payment of $25,670.82 with respect to the interest owing on the $152,419.01 tax was made and credited to Barcal's account. The total amount of refund being sought by Barcal in this case is tax in the amount of $152,419.01 and interest of $123,251.81.

25. Payment of $4,076.02 made to BBI on May 21, 1984 was credited against the revised tax of $1,678.46 and interest on such amounts of $1,505.06. The remaining amount of $892.50 was subsequently refunded to BBI with interest as provided by law. These additional payments of $1,678.46 of tax and $1,505.06 of interest are the amounts for which BBI is seeking a refund in this action.

26. The FTB, through its attorney Marvin J. Halpern ("Halpern"), and BBI and Barcal, through their attorney Joanne M. Garvey ("Garvey"), have corresponded regarding, *inter alia*, plaintiffs' respective Section 25137 petitions for the income years ending September 30, 1977, 1978 and 1979 and December 1, 1979. In addition members of the FTB or the FTB staff have drafted certain documents concerning Section 25137 petitions. These documents include:

26a. Letter from Garvey to Halpern dated May 18, 1984.

26b. Letter from H. Barry Berlin to California Franchise Tax Board, dated May 22, 1984.

26c. Photocopies of checks numbers 45007-45009 of BBI, dated May 21, 1984 drawn on Barclays Bank International Limited account payable to the Franchise Tax Board.

26d. Letter from Halpern to Garvey dated June 22, 1984.

26e. Letter from Garvey to Halpern dated June 28, 1984.

26f. Letter from Halpern to Garvey dated July 24, 1984.

26g. Letter from Garvey to Halpern dated September 11, 1984.

26h. Letter (via Telex) from Garvey to Halpern dated November 9, 1984.

26i. Letter from Halpern to Garvey dated January 28, 1985.

26j. FTB's Notice of Action on Taxpayer's Protest to Barcal, dated February 15, 1985.

26k. FTB's Notice of Action on Taxpayer's Protest to BBI, dated February 15, 1985.

26l. Letter from Garvey to Halpern, dated June 28, 1985.

26m. Letter from Halpern to Garvey dated January 8, 1986.

26n. Exhibit No. 3 to Marvin Halpern's deposition taken January 16-17, 1986, entitled "Statement of the Franchise Tax Board Pertaining to Section 25137 Petitions."

26o. Memorandum from Martin Huff to Walter Harvey, concerning "Petitions for Relief under Section 25137 Bank and Corporation Tax Law," dated June 23, 1977.

26p. Memorandum from Benjamin F. Miller to Martin Huff, Executive Officer, concerning "Meeting with Dennis Amundsun, Director Department for Eco-

nomic and Business Development," dated March 21, 1978.

26q. Memorandum from Marvin J. Halpern to Glenn L. Rigby dated July 25, 1984.

26r. Letter from R.E. Gilbert to the California Franchise Tax Board, dated October 31, 1983.

27. For purposes of this litigation only, BBI and Barcal agree that for income year 1977 they were members of a worldwide unitary business within the meaning of Revenue and Taxation Code Section 25101, *et seq.*, composed of the members of the Barclays Group.

28. On September 23, 1983, United States Secretary of Treasury, Donald T. Regan, announced the establishment of the Worldwide Unitary Taxation Working Group ("Working Group").

29. The Final Report of the Worldwide Unitary Taxation Working Group, Chairman's Report and Supplemental Views, August 1984, was transmitted to the President of the United States on August 31, 1984.

30. Among those testifying before, or submitting reports to, the Working Group or the Task Force of the Working Group were:

30a. Statement of the United Kingdom before the United States Treasury Working Group on Worldwide Unitary Taxation.

30b. Presentation by Mr. Barry Pollard, Inland Revenue, on United Kingdom Experience of Operating the Arms Length Principle With Special Reference to Transfer Pricing Enquiries.

30c. Statement of Canada before the United States Worldwide Unitary Taxation Working Group.

30d. Submission of the Australian Government to the U.S. Task Force on Unitary Taxation, dated January 4, 1984.

31. Trial Exhibit 31 to this stipulation is a true and accurate summary chart of the country of incorporation and the financial operating profit in pounds sterling of the members of the Barclays Group as set forth in the business records of the companies comprising the Group, prepared in the ordinary course of business and used, among other things, for the preparation of the Reports and Accounts of the Barclays Group.

32. Foreign governments, on their own behalf or as the representatives of official governmental bodies such as the European Economic Community (EEC), have sent communications (collectively trial Exhibit 32) to the United States government and to the several states of the United States, including California, expressing objections to use by the states, including California, of the worldwide combined reporting unitary method of state taxation. Some of these are:

32a. Letter from Hon. Nigel Lawson, Chancellor of the Exchequer for the United Kingdom to the United States Secretary of the Treasury, Hon. Donald T. Regan, dated July 12, 1983.

32b. Demarche from Italy, as President of the EEC, on behalf of the Nine European Economic Community Governments to the Department of State, Washington, D.C., dated March 19, 1980.

32c. Demarche No. 51 from the United Kingdom Embassy to the Department of State, Washington, D.C., dated March 25, 1980.

32d. Demarche No. 211 from the United Kingdom, as President of the EEC, on behalf of the Ten European Economic Community Governments to the Department of State, Washington, D.C., dated October 30, 1981.

32e. Demarche No. 692 from the Embassy of Canada to the Department of State, Washington, D.C., dated December 22, 1981.

32f. Demarche No. 83 from the United Kingdom Embassy to the Department of State, Washington, D.C., dated May 18, 1982.

32g. Demarche No. 283 from the Embassy of Canada to the Department of State, Washington, D.C., dated June 14, 1982.

32h. Demarche from the Government of Belgium as President of the EEC, on behalf of the ten European Economic Community Governments to the Department of State, Washington, D.C., dated June 29, 1982.

32i Demarche from Greece, as President of the EEC, on behalf of the ten European Economic Community Governments to the Department of State, Washington, D.C., dated August 1, 1983.

32j. Demarche No. 481 from the Embassy of Canada to the Department of State, Washington, D.C., dated September 28, 1983.

32k. Demarche No. 383/83 from the Embassy of Australia to the Department of State, Washington, D.C., dated November 7, 1983.

32l. Demarche No. 461.20-LJ/hu from the Embassy of Switzerland to the Department of State, Washington, D.C., dated November 15, 1983.

32m. Demarche from the Federal Republic of Germany to the Department of State, Washington, D.C., dated November 28, 1983.

32n. Demarche No. EA-14533 from the Embassy of the Kingdom of the Netherlands to the Department of State, Washington, D.C., dated December 21, 1983.

32o. Demarche from the Embassy of Belgium on behalf of the ten European Economic Community Governments, the European Commission and the Embassies of Australia, Canada, Japan and Switzerland to the Department of State, Washington, D.C., dated January 25, 1984.

32p. Demarche from the Embassy of Belgium to the Department of State, Washington, D.C., dated January 25, 1984.

32q. Demarche No. 634 from the Embassy of Canada to the Department of State, Washington, D.C., dated February 27, 1984.

32r. Aide-memoire from the Government of Japan to the United States Government dated June 6, 1984.

32s. Official correspondence from the Hon. Marc Lalonde, Minister of Finance for Canada to the United States Secretary of the Treasury, Hon. Donald T. Regan, dated August 11, 1983.

32t. Letter from W. Wachtmeister, Swedish Ambassador to the United States, and the Governments of Australia, Austria, Belgium, Canada, Denmark, Finland, France, the Federal Republic of Germany, Greece, Ireland, Italy, Japan, Luxembourg, Norway, the Kingdom of the Netherlands, Sweden, Switzerland, the United Kingdom and the Commission of the European Communities to the Hon. Robert Bangter, Governor of the State of Utah, dated February 15, 1985.

32u. Letter from J.L. Beaven, United Kingdom Consul-General to the United States, to the Hon. Willie L. Brown, Jr., Speaker of the California Assembly, dated June 18, 1984.

32v. Letter from W. Wachtmeister, Swedish Ambassador to the United States, and the Governments of Australia, Austria, Belgium, Canada, Denmark, Finland, France, the Federal Republic of Germany, Greece, Ireland, Italy, Japan, Luxembourg, Norway, Sweden, Switzerland, the United Kingdom and the Commission of the European Communities to the Honorable

Richard D. Lamm, Governor of the State of Colorado, dated January 25, 1985.

32w. Letter from W. Wachtmeister, Swedish Ambassador to the United States, and the Governments of Australia, Austria, Belgium, Canada, Denmark, Finland, France, the Federal Republic of Germany, Greece, Ireland, Italy, Japan, Luxembourg, Norway, the Kingdom of the Netherlands, Sweden, Switzerland, the United Kingdom and the Commission of the European Communities to the Hon. George A. Sinner, Governor of the State of North Dakota, dated March 18, 1985.

32x. Letter from Jacques S. Roy of the Embassy of Canada to the Hon. Robert Graham, Governor of the State of Florida, dated May 30, 1984.

32y. Letter from J. Raoul Schoumaker of the Embassy of Belgium and the Governments of Australia, Austria, Belgium, Canada, Denmark, Finland, France, the Federal Republic of Germany, Greece, Ireland, Italy, Japan, Luxembourg, The Kingdom of the Netherlands, Sweden, Switzerland, the United Kingdom and the Commission of the European Communities to the Hon. Robert Graham, Governor of the State of Florida, dated November 28, 1984.

32z. Letter from H.G. Walsh, Counsellor (Economic) British Embassy Washington, D.C. to the Honorable Edmund G. Brown, Governor of the State of California, dated October 30, 1981.

32aa. Letter from Christopher E. F. Davis, Consul Canadian Consulate, San Francisco, California to Gerald Goldberg, Executive Officer Franchise Tax Board of California, dated January 26, 1984.

32bb. Letter from J. L. Beaven, Her Majesty's Consul-General to the Honorable George Deukmejian, Governor of California, dated June 21, 1983.

32cc. Letter from the United Kingdom Chancellor of the Exchequer to the Secretary of the United States Treasury dated June 20, 1985.

32dd. Undated Memorandum from the Netherlands Government to the Governor of California.

32ee. Letter from the Hon. Pierre Trudeau to Hon. Ronald Reagan, President of the United States, dated September 24, 1983.

33. The following documents pertaining to treaties of Friendship, Commerce, and Navigation were provided to Benjamin F. Miller, Counsel for Multistate Tax Affairs for the FTB, by the Department of State:

33a. The first page and pages 15 and 16 of a Memorandum to the Embassy at Chungking for Use in Negotiating Treaty of Friendship, Commerce and Navigation. These pages, constituting the only pages received of the above-mentioned document by the FTB were enclosures to the letter dated August 22, 1980 referred to in paragraph 33(c).

33b. The first page and pages 16 through 19 of a Memorandum to the American Embassy at Rio de Janeiro for Use in Negotiating Treaty of Friendship, Commerce and Navigation Between the United States and Brazil. These pages, constituting the only pages received of the above-mentioned document by the FTB, were enclosures to the letter dated August 22, 1980 referred to in paragraph 33(c).

33c. The cover page and pages ii, 19, 20, 21, 202 and 203 of a preliminary draft of a study entitled *Standard Draft Treaty of Friendship, Commerce and Navigation* prepared under contract to the Department of State by Charles H. Sullivan. These pages, constituting the only pages received of the above-mentioned document by the FTB, were enclosures to a letter dated August 22, 1980 and

signed by Stuart E. Benson, Acting Assistant Legal Advisor, Office of the Legal Advisor, Department of State, addressed to D. R. Milton, Vice President Tax, Shell Oil Company, Houston, Texas carbon copy to Benjamin F. Miller, Franchise Tax Board, State of California.

33d. Pages 13a through 15 of Annotated Draft FCN for Portugal prepared by Herman Walker. These pages, constituting the only pages received of the above-mentioned document by the FTB, were enclosures to the letter dated August 22, 1980 referred to in paragraph 33(c).

33e. HICOG Bonn Despatch No. 2255 of February 17, 1954, pages 1 through 5 inclusive, with two page attachment No. 1868. These documents were enclosures to the letter dated August 22, 1980 referred to in paragraph 33(c).

33f. A three page Airgram of the Department of the State dated July 3, 1983 concerning FCN Treaty with the Netherlands, and replying to Embassy dispatch 1472. This document was an enclosure to a letter dated August 28, 1980, from Stuart E. Bensen, Acting Assistant, Legal Advisor, Office of the Legal Advisor, addressed to D.R. Milton, Vice President of Tax, Shell Oil Company, Houston, Texas, carbon copy to Benjamin F. Miller, Franchise Tax Board.

33g. Letter dated February 11, 1981 from Theodore W. Kassinger, Attorney Advisor, Office of Assistant Legal Advisor for Economic and Business Affairs, Department of State.

34. On July 9-10, 1985, the Parliament of the United Kingdom debated and unanimously passed legislation in Clause 27 of the Finance Act of 1985. The proceedings of Parliament are truly and accurately reported in the House of Commons Official Report,

Parliamentary Debates (Hansard), Wednesday 10 July 1985, Volume 82, No. 152.

35. The United Kingdom's Finance Act of 1985.

36. There have been discussions and debates in, and documents presented to, the United States Congress concerning the use by the states of worldwide combined reporting, some of which are reported as follows:

36a. Statement of Senators Wilson and Mathias and Statement by the President of the United States in support of the Unitary Tax Repealer Act. 131 Cong. Rec. 17975-17978 (1985).

36b. Executive Session and Statement of Senator Hiyakawa regarding consideration of the United Kingdom-United States treaties. 125 Cong. Rec. 17427-17435, 17796 (1979).

36c. Executive session regarding consideration of tax convention with the United Kingdom. 124 Cong. Rec. 18402-18430 (1978).

36d. Executive session continued regarding consideration of tax convention with the United Kingdom. 124 Cong. Rec. 18651-18670, 18709-18712 and 19076-19078 (1978).

36e. Introduction of H.R. 3980 by Hon. John J. Duncan as reported in the Congressional Record of December 19, 1985 on pages E5754 and 5755 (extension of remarks)

37. Various committees of the United States Congress have held hearings on the issues of state taxation, including the use by the states of worldwide combined reporting, which committees' proceedings, some of which have been transcribed or which committees have issued reports, as follows:

37a. Committee on Ways and Means, 95th Congress, 1st Sess., Recommendations of the Task Force on Foreign Source Income (Comm. Print 1977).

37b. Senate Committee on Foreign Relations, Third Protocol to the 1975 Income Tax Convention With the United Kingdom of Great Britain, and Northern Ireland, as Amended, S. Doc. No. 5, 96th Congress, 1st Sess. (1979).

37c. Tax Treaties With the United Kingdom, the Republic of Korea, and the Republic of the Philippines, 1977: Hearings Before the Senate Committee on Foreign Relations, 96th Congress, 1st Sess. (1977).

37d. State Taxation of Foreign Source Income, 1980: Hearings on H.R. 5076 Before the House of Representatives Committee on Ways and Means, 86th Congress, 2d Sess. (1980).

37e. State Taxation of Interstate Commerce and Worldwide Corporate Income, 1980: Hearings on S. 983 and S. 1688 Before the Subcomm. on Taxation and Debt Management Generally of the Senate Comm. on Finance, 96th Congress, 2d. Sess. (1980).

37f. Unitary Taxation, 1984: Hearings before the Subcomm. on International Economic Policy of the Senate Foreign Relations Comm., 98th Cong., 2d Sess. (1984).

37g. Interstate Taxation, S. 2173: Hearings before the Senate Committee on the Judiciary, 95th Cong., 1st and 2nd Sess. (1977-1978).

38. Various proposed Legislative bills have been introduced in the United States Congress that would, among other things, affect the states' use of worldwide combined reporting. Some of these bills are:

38a. H.R. 11798 (Willis) (1965)

38b. S. 916 (Ribicoff) (1969)

38c. S. 317 (Ribicoff) (1971)

38d. S. 4080 (Mathias) (1972)

38e. S. 2173 (Mathias) (1977)

38f. S. 1688 (Mathias) (1979)

38g. H.R. 5076 (Conable) (1979)

38h. H.R. 5903 (Satterfield) (1979)

38i. H.R. 8277 (Broyhill) (1980)

38j. H.R. 1983 (Conable) (1981)

38k. H.R. 6402 (Rodino) (1982)

38l. H.R. 2918 (Conable) (1983)

38m. H.R. 3243 (Frenzel) (1983)

38n. S. 1225 (Mathias) (1983)

38o. H.R. 4940 (Wyden) (1984)

38p. H.R. 6146 (Mica) (1984)

38q. S. 3061 (Hawkins) (1984)

38r. H.R. 3980 (Duncan) (1985)

38s. S. 1113 (Mathias) (1985)

38t. S. 1974 (Wilson) (1985)

39. The FTB and various committees of the California State Legislature have held hearings on California's use of world-wide combined reporting, some of which have been transcribed, as follows:

39a. Hearing of State of California Franchise Tax Board, Monday, August 22, 1977, 9:30 a.m.

39b. Hearing of State of California Franchise Tax Board, Tuesday, July 12, 1977, 10:00 a.m.

39c. Hearing, Assembly Revenue and Taxation Committee, Willie L. Brown, Jr., Chairman, Los Angeles, November 1979.

39d. Interim Hearing, Assembly Committee on Revenue and Taxation, San Diego, November 7, 1980.

40. As of January 30, 1986, the United States was a party to income tax treaties for the avoidance of double taxation with thirty-three (33) countries, as follows:

40a. Convention between the Government of the United States of America and the Government of Australia for the Avoidance of Double Taxation, signed August 6, 1982, entered into force October 31, 1983.

40b. Convention between the Government of the United States of America and the Government of Australia for the Avoidance of Double Taxation, signed October 25, 1956, entered into force October 10, 1957.

40c. Convention between the Government of the United States of America and the Government of Belgium for the Avoidance of Double Taxation, signed July 9, 1970, entered into force October 13, 1972.

40d. Convention between the Government of the United States of America and the Government of Canada for the Avoidance of Double Taxation, signed September 26, 1980, amended by protocols signed June 14, 1983 and March 23, 1984, entered into force August 16, 1984.

40e. Convention between the Government of the United States of America and the Government of Denmark for the Avoidance of Double Taxation, signed May 6, 1948, entered into force December 1, 1948.

40f. Convention between the Government of the United States of America and the Government of Egypt for the Avoidance of Double Taxation, signed August 24, 1980, entered into force December 31, 1981.

40g. Convention between the Government of the United States of America and the Government of Finland for the Avoidance of Double Taxation, signed March 6, 1970, entered into force February 28, 1971.

40h. Convention between the Government of the United States of America and the Government of France for the Avoidance of Double Taxation, signed June 28, 1967, entered into force August 11, 1968, modified by protocol signed October 12, 1970, entered into force February 21, 1971, modified by protocol dated November 24, 1978, entered into force October 27, 1979.

40i. Convention between the Government of the United States of America and the Government of the Federal Republic of Germany for the Avoidance of Double Taxation, signed July 22, 1954, entered into force December 20, 1954, modified by protocol signed September 17, 1965, entered into force December 27, 1965.

40j. Convention between the Government of the United States of America and the Government of Greece for the Avoidance of Double Taxation, signed April 20, 1953, amended by protocol dated April 20, 1953, entered into force December 30, 1953.

40k. Convention between the Government of the United States of America and the Government of Hungary for the Avoidance of Double Taxation, signed February 12, 1979, entered into force September 18, 1979.

40l. Convention between the Government of the United States of America and the Government of Iceland for the Avoidance of Double Taxation, signed May 7, 1975, entered into force December 26, 1975.

40m. Convention between the Government of the United States of America and the Government of Ireland for the Avoidance of Double Taxation, signed September 13, 1949, entered into force December 20, 1951.

40n. Convention between the Government of the United States of America and the Government of Italy for the Avoidance of Double Taxation, signed March 30, 1955, entered into force October 26, 1956.

40o. Convention between the Government of the United States of America and the Government of Jamaica for the Avoidance of Double Taxation, signed May 21, 1980, amended by protocol signed May 21, 1980, entered into force December 29, 1981.

40p. Convention between the Government of the United States of America and the Government of Japan for the Avoidance of Double Taxation, signed March 8, 1971, entered into force July 9, 1972.

40q. Convention between the Government of the United States of America and the Government of Korea for the Avoidance of Double Taxation, signed June 4, 1976, entered into force October 29, 1979.

40r. Convention between the Government of the United States of America and the Government of Luxembourg for the Avoidance of Double Taxation, signed December 18, 1962, entered into force December 22, 1984.

40s. Convention between the Government of the United States of America and the Government of Malta for the Avoidance of Double Taxation, signed March 21, 1980, entered into force May 18, 1982.

40t. Convention between the Government of the United States of America and the Government of Morocco for the Avoidance of Double Taxation, signed August 1, 1977, entered into force December 30, 1981.

40u. Convention between the Government of the United States of America and the Government of the Kingdom of the Netherlands for the Avoidance of Double Taxation, signed April 29, 1948, entered into

force December 1, 1948, as modified by supplementary convention signed December 30, 1965, entered into force July 8, 1966.

40v. Convention between the Government of the United States of America and the Government of New Zealand for the Avoidance of Double Taxation, signed July 23, 1982, entered into force November 2, 1983.

40w. Convention between the Government of the United States of America and the Government of Norway for the Avoidance of Double Taxation, signed December 3, 1971, entered into force November 29, 1972, modified by protocol signed September 19, 1980, entered into force December 15, 1981.

40x. Convention between the Government of the United States of America and the Government of Pakistan for the Avoidance of Double Taxation, signed July 1, 1957, entered into force May 21, 1959.

40y. Convention between the Government of the United States of America and the Government of the Philippines for the Avoidance of Double Taxation, signed October 1, 1976, entered into force October 16, 1982.

40z. Convention between the Government of the United States of America and the Government of Poland for the Avoidance of Double Taxation, signed October 8, 1974, entered into force June 22, 1976.

40aa. Convention between the Government of the United States of America and the Government of Romania for the Avoidance of Double Taxation, signed December 4, 1973, entered into force February 26, 1976.

40bb. Convention between the Government of the United States of America and the Government of Sweden for the Avoidance of Double Taxation, signed March 23,

1939, entered into force November 14, 1939, modified by supplementary convention signed October 22, 1963, entered into force September 11, 1964.

40cc. Convention between the Government of the United States of America and the Government of Switzerland for the Avoidance of Double Taxation, signed May 24, 1951, entered into force September 22, 1951.

40dd. Convention between the Government of the United States of America and the Government of Trinidad and Tobago for the Avoidance of Double Taxation, signed January 9, 1970, entered into force December 30, 1970.

40ee. Convention between the Government of the United States of America and the Government of the Republic of South Africa for the Avoidance of Double Taxation, signed December 13, 1946, entered into force July 15, 1952, modified by supplementary protocol signed July 14, 1950, entered into force July 15, 1952.

40ff. Convention between the Government of the United States of America and the Government of the Union of Soviet Socialist Republics for the Avoidance of Double Taxation, signed June 20, 1973, entered into force January 29, 1976.

40gg. Convention between the Government of the United States of America and the Government of the Kingdom of Great Britain and Northern Ireland for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and Capital Gains, signed December 31, 1975, entered into force April 25, 1980, modified by notes exchanged on April 13, 1976, amended by first protocol signed August 26, 1976, second protocol

signed March 31, 1977, and third protocol signed March 15, 1979, all entered into force July 25, 1980.

41. As of December 16, 1985, the United Kingdom was a party to seventy-eight (78) treaties for the avoidance of double taxation on income, as follows:

41a. Double Taxation Relief (Antigua) Order 1947 (S.R. & O 1947 No. 2865), amended (S.I. 1968 No. 1096).

41b. Double Taxation Relief (Australia) Order 1967 (S.I. 1968 No. 305), protocol (S.I. 1980 No. 707).

41c. Double Taxation Relief (Austria) Order 1970 (S.I. 1947 No. 1947), protocol 1980 (S.I. 1979 No. 117).

41d. Double Taxation Relief (Bangladesh) Order 1979 (S.I. 1980 No. 1947), protocol 1980 (S.I. 1979 No. 708).

41e. Double Taxation Relief (Barbados) Order 1970 (S.I. 1970 No. 952), protocol 1973 (S.I. 1973 No. 2096).

41f. Double Taxation Relief (Belgium) Order 1967 (S.I. 1970 No. 636).

41g. Double Taxation Relief (Belize) Order 1947 (S.R. & O 1947 No. 2866), amended 1962 (S.I. 1968 No. 573), amended 1973 (S.I. 1973 No. 2097).

41h. Double Taxation Relief (Botswana) Order 1977 (S.I. 1978 No. 183).

41i. Double Taxation Relief (Brunei) Order 1950 (S.I. 1950 No. 1977), amended 1968 (S.I. 1968 No. 306), amended 1973 (S.I. 1973 No. 2098).

41j. Double Taxation Relief (Burma) Order 1950, protocol 1951 (S.I. 1952 No. 751).

41k. Double Taxation Relief (Canada) Order 1978 (S.I. 1980 No. 709), protocol 1980 (S.I. 1980 No. 1528), protocol (S.I. 1985 No. 1996).

41l. Double Taxation Relief (China) Order 1984 (S.I. 1984 No. 1826).

41m. Double Taxation Relief (Cyprus) Order 1974 (S.I. 1975 No. 425), protocol 1980 (S.I. 1980 No. 1529).

41n. Double Taxation Relief (Denmark) Order 1980 (S.I. 1980 No. 1960).

41o. Double Taxation Relief (Dominican Republic) Order 1949 (S.I. 1949 No. 359), amended 1968 (S.I. 1968 No. 1098).

41p. Double Taxation Relief (Egypt) Order 1980 (S.I. 1980 No. 1091).

41q. Double Taxation Relief (Falkland Islands) Order 1984 (S.I. 1984 No. 363).

41r. Double Taxation Relief (Faroe Islands) Order 1950 (S.I. 1950 No. 1195), extended 1960 (S.I. 1961 No. 579), protocol 1969 (S.I. 1969 No. 1068), extended 1970 (S.I. 1971 No. 717), protocol 1973 (S.I. 1973 No. 1326), extended 1975 (S.I. 1975 No. 2190).

41s. Double Taxation Relief (Fiji) Order 1975 (S.I. 1976 No. 1342).

41t. Double Taxation Relief (Finland) Order 1969 (S.I. 1970 No. 153), protocol 1979 (S.I. 1980 No. 710), protocol 1984 (S.I. 1985 No. 1997).

41u. Double Taxation Relief (France) Order 1968 (S.I. 1968 No. 1869), protocol 1973 (S.I. 1973 No. 1328).

41v. Double Taxation Relief (Gambia) Order 1980 (S.I. 1980 No. 1963).

41w. Double Taxation Relief (Federal Republic of Germany) Order 1964 (S.I. 1967 No. 25), protocol 1970 (S.I. 1971 No. 874).

41x. Double Taxation Relief (Ghana) Order 1977 (S.I. 1978 No. 785).

41y. Double Taxation Relief (Greece) Order 1953 (S.I. 1954 No. 142).

41z. Double Taxation Relief (Grenada) Order 1949 (S.I. 1949 No. 361), amended 1968 (S.I. 1968 No. 1867).

41aa. Double Taxation Relief (Guernsey) Order 1952 (S.I. 1952 No. 1215).

41bb. Double Taxation Relief (Hungary) Order 1977 (S.I. 1978 No. 1056).

41cc. Double Taxation Relief (India) Order 1981 (S.I. 1981 No. 1120).

41dd. Double Taxation Relief (Indonesia) Order 1975 (S.I. 1975 No. 2191).

41ee. Double Taxation Relief (Republic of Ireland) Order 1976 (S.I. 1976 No. 2151), protocol 1976 (S.I. 1976 No. 2152).

41ff. Double Taxation Relief (Isle of Man) Order 1955 (S.I. 1955 No. 1205).

41gg. Double Taxation Relief (Israel) Order 1962 (S.I. 1962 No. 616), protocol 1970 (S.I. 1971 No. 391).

41hh. Double Taxation Relief (Italy) Order 1960, exchange of notes 1960 (S.I. 1962 No. 2787), protocol 1969 (S.I. 1973 No. 1763).

41ii. Double Taxation Relief (Jamaica) Order 1973 (S.I. 1973 No. 1329).

41jj. Double Taxation Relief (Japan) Order 1969, exchange of notes 1969 (S.I. 1970 No. 1948), protocol 1980 (S.I. 1980 No. 1530).

41kk. Double Taxation Relief (Jersey) Order 1952 (S.I. 1952 No. 1216).

41ll. Double Taxation Relief (Kenya) Order 1973, protocol 1976, exchange of notes 1977 (S.I. 1977 No. 1299).

41mm. Double Taxation Relief (Kiribati and Tuvalu) Order 1950 (S.I. 1950 No. 750), amended 1968 (S.I. No. 309), amended 1974 (S.I. 1974 No. 1271).

41nn. Double Taxation Relief (Korea) Order 1977, protocol 1977 (S.I. 1978 No. 786).

41oo. Double Taxation Relief (Lesotho) Order 1949 (S.I. No. 2197), amended 1968 (S.I. 1968 No. 1868).

41pp. Double Taxation Relief (Luxembourg) Order 1967 (S.I. 1968 No. 1100), protocol 1978 (S.I. 1980 No. 567), protocol 1983 (S.I. 1984 No. 364).

41qq. Double Taxation Relief (Malawi) Order 1955 (S.I. 1956 No. 619), amended 1964 (S.I. 1964 No. 1401), amended 1968 (S.I. 1968 No. 1101), amended 1978 (S.I. 1978 No. 302).

41rr. Double Taxation Relief (Malaysia) Order 1973, protocol 1973 (S.I. 1973 No. 1330).

41ss. Double Taxation Relief (Malta) Order 1962 (S.I. 1962 No. 639), amended 1974 (S.I. 1975 No. 426).

41tt. Double Taxation Relief (Mauritius) Order 1981 (S.I. 1981 No. 1121).

41uu. Double Taxation Relief (Montserrat) Order 1947 (S.I. 1947 No. 2868), amended 1968 (S.I. 1968 No. 576).

41vv. Double Taxation Relief (Namibia) Order 1962 (S.I. 1962 No. 2352), extended 1962 (S.I. 1962 No. 2788), protocol 1967 (S.I. 1967 No. 1489), extended 1967 (S.I. 1967 No. 1460).

41ww. Double Taxation Relief (Netherlands) Order 1980 (S.I. 1980 No. 1961), protocol 1983 (S.I. 1983 No. 1902).

41xx. Double Taxation Relief (Netherlands Antilles) Order 1967 (S.I. 1968 No. 577), extended 1970 (S.I. 1970 No. 1949).

41yy. Double Taxation Relief (New Zealand) Order 1983, exchange of notes 1983 (S.I. 1984 No. 365).

41zz. Double Taxation Relief (Norway) Order 1985 (S.I. 1985 No. 1998).

41aaa. Double Taxation Relief (Pakistan) Order 1961 (S.I. 1961 No. 2467).

41bbb. Double Taxation Relief (Philippines) Order 1976 (S.I. 1978 No. 184).

41ccc. Double Taxation Relief (Poland) Order 1976 (S.I. 1978 No. 282).

41ddd. Double Taxation Relief (Portugal) Order 1968 (S.I. 1969 No. 599).

41eee. Double Taxation Relief (Romania) Order 1975, exchange of notes 1976 (S.I. 1977 No. 57).

41fff. Double Taxation Relief (St. Christopher & Nevis (St. Kitts)) Order 1947 (S.I. 1947 No. 2872).

41ggg. Double Taxation Relief (St. Lucia) Order 1949 (S.I. 1949 No. 366), amended 1968 (S.I. 1968 No. 1102).

41hhh. Double Taxation Relief (St. Vincent & Grenadines) Order 1949 (S.I. 1949 No. 367), amended 1968 (S.I. 1968 No. 1103).

41iii. Double Taxation Relief (Sierra Leone) Order 1947 (S.I. 1947 No. 2873), amended 1968 (S.I. 1968 No. 1104).

41jjj. Double Taxation Relief (Singapore) Order 1966 (S.I. 1967 No. 483), protocol 1975, exchange of notes 1975, 1976, 1977 (S.I. 1978 No. 787).

41kkk. Double Taxation Relief (Solomon Islands) Order 1950 (S.I. 1950 No. 748), amended 1968 (S.I. 1968 No. 574), amended 1974 (S.I. 1974 No. 1270).

41lll. Double Taxation Relief (South Africa) Order 1968 (S.I. 1969 No. 864).

41mmm. Double Taxation Relief (Spain) 1975 (S.I. 1976 No. 1919).

41nnn. Double Taxation Relief (Sri Lanka) Order 1979, exchange of notes 1980 (S.I. 1980 No. 713).

41ooo. Double Taxation Relief (Sudan) Order 1975 (S.I. 1979 No. 1719).

41ppp. Double Taxation Relief (Swaziland) Order 1968 (S.I. 1968 No. 380).

41qqq. Double Taxation Relief (Sweden) Order 1983 (S.I. 1984 No. 366), protocol 1984 (S.I. 1984 No. 366).

41rrr. Double Taxation Relief (Switzerland) Order 1977 (S.I. 1978 No. 1408), protocol 1981 (S.I. 1982 No. 714).

41sss. Double Taxation Relief (Thailand) Order 1981 (S.I. 1981 No. 1546).

41ttt. Double Taxation Relief (Trinidad & Tobago) Order 1982 (S.I. 1983 No. 1903).

41uuu. Double Taxation Relief (Tunisia) Order 1982 (S.I. 1984 No. 1336).

41vvv. Double Taxation Relief (Uganda) Order 1952 (S.I. 1952 No. 1213).

41www. Double Taxation Relief (United States of America) Order 1975, exchange of notes 1976, protocol 1976, protocol 1977, protocol 1979 (S.I. 1980 No. 568).

41xxx. Double Taxation Relief (Yugoslavia) Order 1981 (S.I. 1981 No. 1815).

41yyy. Double Taxation Relief (Zambia) Order 1972 (S.I. 1972 No. 1721), protocol 1981 (S.I. 1981 No. 1816).

41zzz. Double Taxation Relief (Zimbabwe) Order 1982 (S.I. 1982 No. 1842)).

42. By an exchange of notes dated September 26, 1980, between the Honorable Allan J. MacEachen, Deputy Prime Minister and Minister of Finance of Canada and G. William Miller,

Secretary of Treasury of the United States, in conjunction with the execution of the Convention For Avoidance of Double Taxation between the United States and Canada, the Government of Canada set forth its position on the issue of the so-called "unitary apportionment" method used by certain states of the United States and the United States agreed to reopen discussions with Canada on this subject if an acceptable provision on this subject can be devised.

43. By an exchange of notes dated November 24, 1978, between George S. Vest, Assistant Secretary of State for European Affairs, and Francois de Laboulaye, Ambassador of France, in conjunction with the execution of the protocol dated November 24, 1978, to the Convention for the Avoidance of Double Taxation between the United States and France, the Government of France set forth its position on the so-called "unitary apportionment" method used by certain states of the United States, and the Government of the United States and the Government of the United States agreed to reopen discussions with France on this subject if an acceptable provision on this subject can be devised.

44. In 1963, the Committee on Fiscal Affairs to the Council of the Organization for Economic Co-operation and Development ("OECD") published the Draft Double Taxation Convention on Income and Capital. In 1977, the OECD revised and published its new Model Double Taxation Convention on Income and on Capital. The conventions are both contained in the 1977 Report of the OECD Committee on Fiscal Affairs, "Model Double Taxation Convention on Income and on Capital."

45. In 1977, the Government of the United States of America published its Model Convention For the Avoidance of Double Taxation on Income and Capital. This document was revised in 1981 and is entitled "United States Draft Model Income Tax Treaty."

46. Correspondence, statements or press releases from various government officials throughout the United States have been issued, some of which are as follows:

46a. Letter from Secretary of Treasury, James A. Baker III to the President of the United States Senate regarding the introduction of Unitary Tax Repealer Act, dated December 18, 1985.

46b. Letter from the Honorable Barber B. Conable, Jr. to the Honorable John E. Chapoton with enclosed statement of the Honorable Conable to be submitted to the Unitary Taxation Group's Task Force, dated November 23, 1983.

46c. Letter to the Honorable Barber B. Conable, Jr. from the Honorable Donald C. Lubick, Assistant Secretary of the Treasury regarding unitary taxation, dated April 22, 1980.

46d. Statement by the Honorable Allen Wallis, Under Secretary of State for Economic Affairs concerning the Chairman's Working Group Report, as taken from the Final Report of the Worldwide Unitary Taxation Group, August 1984.

46e. Statement by the Honorable Donald C. Lubick, Assistant Secretary of the Treasury for Tax Policy, before the Senate Finance Subcommittee on Taxation and Debt Management Generally on S. 983 and S. 1688, dated June 24, 1980.

46f. Statement by the Honorable Donald C. Lubick, Assistant Secretary of the Treasury for Tax Policy, before the House Ways and Means Committee on H.R. 5076, dated March 31, 1980.

46g. Press release #255 from the Office of the Governor of California regarding California's unitary tax, dated May 1, 1984.

46h. Letter from the Honorable George P. Schultz to the Honorable George Deukmejian regarding unitary taxation, dated January 30, 1986

46i. Reply from Honorable George Deukmejian to the letter of January 30, 1986, from the Honorable George P. Schultz.

47. The Organization for Economic Co-operation and Development (OECD) issued a report on transfer pricing entitled "Transfer Pricing and Multinational Enterprises" (Paris OECD, 1979).

48. The Organization for Economic Co-operation and Development (OECD) issued a report on transfer pricing entitled "Transfer Pricing and Multinational Enterprises, Three Taxation Issues" (Paris OECD, 1984).

49. The administration of Internal Revenue Code Section 482 by the Internal Revenue Service, and its effectiveness generally, has been studied and reported on by certain governmental agencies of the United States, as follows:

49a. Comptroller General of the United States, No. GGD-51-81, Report to the Chairman, House Committee on Ways and Means, IRS Could Better Protect U.S. Tax Interests in Determining the Income of Multinational Corporations (September 30, 1981).

49b. Report to the Associate Commissioner of the Internal Revenue Service, Internal Revenue Service of Study of International Cases Involving Section 482 of the Internal Revenue Code (1982).

50. State taxation of multinational corporations has been the subject of reports, some of which are:

50a. "Key Issues Affecting State Taxation of Multi-jurisdictional Corporate Income Need Resolving", a report to the Chairman of the House Committee on Ways and Means from the Comptroller General of

the United States and published on July 1, 1982 in the General Accounting Office.

50b. Report of the Advisory Commission on Intergovernmental Relations, "State Taxation of Multi-national Corporations" dated November 1982.

50c. Report of Advisory On Intergovernmental Relations, "State Taxation of Multinational and Multistate Corporations" dated September 4, 1981.

51. Internal records of members of the Barclays Group were produced by plaintiffs to defendants in discovery, some of which are as follows:

51a. Letter from A. H. Dalton to I. M. Cobbold, Esq., dated August 3, 1979. (000176-000177)

51b. Letter from P. J. Chapman to G. J. Lyall, Esq., dated April 13, 1983. (000594-000595)

51c. Letter from Price Waterhouse to Secretary, Inland Revenue, dated April 1, 1982. (000631-000633)

51d. Letter from J. A. Dally to Price Waterhouse, dated May 13, 1982. (000630)

51e. BBL Reports and Accounts — 1977. (000256-000308)

51f. BBI Reports and Accounts — 1977. (000221-000255)

51g. Preliminary Prospectus dated March 31, 1981 $125,000,000 Barclays North American Capital Corporation % Guaranteed Capital Notes due 2006. (000424-000521)

51h. Barclays International-World of Banking — List of Offices Nov. 1977. (000309-000423)

51i. Barclays Bank International Limited claim for double tax relief — September 30, 1977. (000639-000646)

51j. Reconciliation between agre.d local taxable profit and UK adjusted profit for purposes of double tax relief September 30, 1977. (000801-000828)

51k. A-T Schedule for Barclays Bank of California for the income year 1977. (002064-002092)

51l. Annual Return/Report of Employee Benefit Plan — U.S. Form 5500 and supporting documents. (003131-003160)

51m. Barclays Bank of California U.S. Corporation Income Tax Return for Income Year 1977 — U.S. Form 1120 and supporting documents. (003261-003209)

51n. BBI U.S. Corporate Income Tax for Income Year 1977 — Form 1120F. (003217-003225)

51o. Barclays Bank of California — California tax return for income year ending September 30, 1977. (003266-003250)

51p. BBI California tax return for income year ending September 30, 1977. (003251-003261)

51q. Barclays Group Management Accounts — December 31, 1977. (003610-003614)

51r. Barclays Group-Supporting schedules to financial accounts December 31, 1977. (003615-003629)

51s. The Barclays Group-Divisional Operating Profit; Reconciliation of Financial and Management Results. (003630-003687)

51t. Interest in subsidiaries and associated companies, December 31, 1977.

51u. Consolidation Schedules. (003708-003752)

51v. Letter D. Elvidge, Head Group Taxation Barclays Plc to J.H. Hall, Inland Revenue dated April 14, 1986.

51w. Letter J.H. Hall, Inland Revenue to David Elvidge, Head Group Taxation Barclays Plc, dated April 16, 1986.

This stipulation is made this 9th day of September, 1986.

JOANNE M. GARVEY LAWRENCE W. JORDAN, JR. JOAN K. IRION JORDAN, KEELER & SELIGMAN	JOHN VAN DE KAMP, Attorney General of the State of California EDWARD P. HOLLINGSHEAD, Supervising Deputy Attorney General
By ______________ Joanne M. Garvey Counsel for Plaintiffs	By ______________ Robert Milam Deputy Attorney General Counsel for Defendant

CERTIFICATE OF SERVICE BY MAIL

I, Rhoda L. Fone, declare that I am a citizen of the United States, over the age of 18, and not a party to or interested in the within entitled cause; that I am an employee of JORDAN, KEELER & SELIGMAN, and that my business address is 1400 Alcoa Building, One Maritime Plaza, San Francisco, California 94111; that on November 3, 1986, I served the within JOINT STIPULATION OF FACTS by placing a true copy thereof in a sealed envelope with postage fully prepaid, in the United States Post Office mail box, in the City and County of San Francisco, California addressed as follows:

Robert D. Milam, Esq.
Deputy Attorney General
1515 K Street
Sacramento, California 94244-2550

I declare under penalty of perjury that the foregoing is true and correct.

Executed on November 3, 1986, at San Francisco, California.

____
Rhoda L. Fone

EXHIBIT 2

JOHN K. VAN DE KAMP, Attorney
General of the State of California
TIMOTHY G. LADDISH
Supervising Deputy Attorney General
RICHARD E. NEILSEN
ROBERT D. MILAM
Deputy Attorneys General
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ATTORNEYS FOR DEFENDANT

SUPERIOR COURT OF CALIFORNIA
COUNTY OF SACRAMENTO

BARCLAYS BANK INTERNATIONAL LTD.,
a corporation of the Country of England,
Plaintiff,

vs.

FRANCHISE TAX BOARD,
an agency of the State of California,
Defendant.

Barclays Bank of California
a California Corporation,
Plaintiff,

vs.

FRANCHISE TAX BOARD,
an agency of the State of California,
Defendant.

No. 325059

No. 325061

(Consolidated for Purposes of Trial)

SECOND STIPULATION OF FACTS AND DOCUMENTS

IT IS HEREBY STIPULATED by and between the parties, through their attorneys of record, that the following further facts and documents are agreed to and undisputed. This stipulation shall not be construed as a concession by either party of the relevancy or materiality of any of the facts stipulated, and the parties reserve the right to argue the relevance, materiality or weight of any of the facts stipulated.

All further documents referred to herein or specifically enumerated are compiled under separate cover, have been reviewed by counsel for the parties and their authenticity and foundational basis admitted. The documents shall be entered into evidence. Nothing contained in this stipulation shall prevent a party from introducing at trial any other or further evidence. With permission of Court, documents described in paragraphs 32, 40, and 41 hereof will be deemed admitted in evidence in entirety without physically presenting the same at trial. Either party may refer to said documents in summary form or as individual exhibits at trial or on appeal as evidence admitted at trial.

Nothing contained herein shall be construed as a waiver by any party of its right to review on appeal any question of law or fact arising in this action in the same manner and to the same extent as if the facts set forth herein had been proven in open court.

This stipulation shall only apply to the above-entitled consolidated actions and to any appeals from the judgment of this Court.

FACTS AND DOCUMENTS

The following facts are agreed to and undisputed and the following documents shall be entered into evidence:

28. Continued

28a. Announcement of the Establishment of the Working Group. 48 Fed. Reg. No. 208, page 49570, October 26, 1983.

32. Continued

32ff. Demarche from Greece, as President of the EEC, on behalf of the Ten European Economic Community Governments to the Department of State, Washington D.C. dated September 23, 1983 with attached Note.

32gg. Aide-memoire from the Government of Japan to the United States Government, dated August 11, 1983.

32hh. Demarche from the Embassy of Ireland as President of the EEC, on behalf of the governments of member states and the Commission of the European Communities to the Department of State, dated December 20, 1984.

32ii. Note Verbale of the Delegation of the Commission of the European Communities and the Embassy of Luxembourg on behalf of the EEC, to the Department of State, dated August 8, 1985.

32jj. Demarche from the Ambassador of Luxembourg and the Head of the Delegation of the Commission of the European Communities to the Department of State, dated August 30, 1985 with attached letter to Treasury Secretary Baker dated August 30, 1985 and attached Note Verbal.

32kk. Note on Worldwide Unitary Taxation from J. Raoul Schoumaker, Ambassador of Belgium, on behalf of the Member States of the European Commission and the Ambassador of Australia, Canada, Japan and Switzerland to Under Secretary of State Allen Wallis and Treasury Secretary Donald Regan, dated January 27, 1984 with cover letter, dated January 30, 1984, enclosing the same to Sir Roy Denman, Head of the Delegation of the Commission of the European Communities.

32ll. Motion for Resolution of the EEC dated October 27, 1983.

37. Continued

37h. Hearing before the Committee on Foreign Relations of the United States Senate on Six International Tax Treaties and Protocols, 96th Congress, 1st Sess. (June 6, 1979).

37i. Hearing before the Subcommittee on Taxation and Debt Management of the Congress on Finance on S.1113 and S.1974, 99th Congress, 2d Sess. (September 29, 1986).

46. Continued

46j. Letter from Michael Blumenthal, Secretary of Treasury to Martin Huff, Executive Officer California Franchise Tax Board, February 15, 1977.

46k. Letter from John S. Chapoton, Assistant Secretary Treasury (Tax Policy) to William J. Anderson, Director, General Government Division U.S., GAO Washington D.C., dated July 10, 1981.

46l. Letter from Donald Regan, Secretary of Treasury, to William Brock, United States Trade Representative, dated February 12, 1982.

46m. Letter from William Brock, United States Trade Representative to Donald Regan, Secretary of Treasury, dated February 22, 1982

46n. Letter from Treasury Secretary James A. Baker III to House Ways and Means Committee Chairman, Dan Rostenkowski, dated March 5, 1986.

46o. Letter from Treasury Secretary James A. Baker III to Senate Finance Committee Chairman Bob Packwood, dated March 17, 1986.

46p. Letter from Treasury Secretary James A. Baker III to Speaker of the House of Representatives, Hon. Thomas P. O'Neill, Jr., dated December 18, 1985.

51. Continued

51x. BBI 1977 New York State Tax Return (Doc. No. 32678-3271).

53. The United Nations Model Double Taxation Convention Between Developed and Developing Countries, 1980.

54. United Kingdom Government Statement in Response to the Statement of the President dated November 8, 1985.

55. California Senate Bill 85 (Alquist) signed by Governor Deukmejian September 5, 1986, an act to add Chapter 1.9 (commencing with Section 15365), Chapter 6 (commencing with Section 15397), and Chapter 7 (commencing with Section 15398) to Part 6.7 of Division 3 of, and to add Article 12 (commencing with Section 16429.30) to Chapter 2 of Part 2 of Division 4 of, Title 2 of, the Government Code, to amend Sections 24274, 24344, 24348, 24667, and 24668 of, to amend and renumber Section 25110 of, to add Sections 24411 and 24670 to, and to add and repeal Article 1.5 (commencing with Section 25110) of Chapter 17 of Part 11 of Division 2 of, the Revenue and Taxation Code, relating to taxation.

56. United Kingdom Government Statement in Response to passage of Senate Bill 85, dated 5 September 1986.

57. Memo to File from Benjamin F. Miller regarding UDITPA Regulations 25137(m) and 25137(o) dated September 23, 1981 with attached Proposed Guidelines for the Preparation of Combined Reports which Include Foreign Country Operations.

58. Summary of Comments, Responses and Recommendations on Proposed Regulation 25137(m) Combined Reports Including Foreign Country Operation.

59. Summary of Comments Received Regarding FTB 1046 (12-79) and Department Responses.

60. US/USSR Treaty hearings and documents including letter from George Shultz to Nikolai Patolicher, Report of the Department of State, and the Report of the Senate Foreign Relations Committee.

This stipulation is made this 10th day of November, 1986.

JOANNE M. GARVEY
LAWRENCE W. JORDAN, JR.
JOAN K. IRION
JORDAN, KEELER & SELIGMAN

By ____________________
Joanne M. Garvey
Counsel for Plaintiffs

JOHN VAN DE KAMP,
Attorney General of the State of California
EDWARD P. HOLLINGSHEAD,
Supervising Deputy Attorney General

By ____________________
Robert Milam
Deputy Attorney General
Counsel for Defendant

EXHIBIT 12

[¶ 14-834F] Section 25137-6 [Reg. 25137-6 — CCH.] *Combined Reports Including Foreign Country Operations* — (a) In General.

(1) Unitary Business. A taxpayer is engaged in a unitary business (or a single business within the meaning of Reg. 25120(b)) when its activities within the state contribute to or are dependent upon its activities without the state. A unitary business exists when there is unity of ownership, unity of operation and unity of use.

(2) Translation Method for Determining Income. The translation method to be used for determining income shall be the "profit and loss method" as set forth in this regulation. This method excludes unrealized exchange rate gain or loss resulting from the restatement of assets or liabilities, while taking into account exchange gains or losses attributable to income transactions.

(3) General Applicability of UDITPA Regulations. The general regulations for UDITPA, Regs. 25120 — 25139, inclusive, shall be applicable except as otherwise provided in this regulation.

(b) Determination of Income.

(1) The income of a unitary business with operations in foreign countries shall be computed in the following manner:

(A) A profit and loss statement shall be prepared for each foreign branch or corporation in the currency in which the books of account of the branch or corporation are regularly maintained.

(B) Adjustments shall be made to the profit and loss statements to conform it to the accounting principles generally accepted in the United States for the preparation of such statements except as modified by this regulation.

(C) Adjustments shall be made to the profit and loss statement to conform it to the tax accounting standards required under Division 2 Part 11 of the Revenue and Taxation Code.

(D) The profit and loss statement of each branch or corporation, whether U.S. or foreign, shall be translated into currency in which the parent company maintains its books and records in accordance with subsection (b)(4).

(E) Business and nonbusiness income as determined under California law shall be identified and segregated. For general definition, rules and examples for determining business and nonbusiness income, see Regulation 25120.

(F) Nonbusiness income shall be allocated to a specific state pursuant to the provisions of Sections 25124 to 25127, inclusive of Division 2 Part 11 of the Revenue and Taxation Code.

(G) Business income shall be included in the combined report prepared for the unitary business and shall be apportioned on the basis of the appropriate formula for the business.

(H) Income from California sources shall be expressed in dollars in accordance with subsection (b)(4) and the taxes computed accordingly.

(2) In lieu of the procedures set forth in subsection (b)(1) and subject to the determination of the Franchise Tax Board that it reasonably reflects income, a unitary business with operations in a foreign country may determine its income on the basis of the consolidated profit and loss statement prepared for the related corporations of which the unitary business is a member which is prepared for filing with the Securities and Exchange Commission. If the business is not required to file with the Securities and Exchange Commission, the consolidated profit and loss statement prepared for reporting to shareholders and subject to review by an independent auditor may be used.

(A) Adjustments shall be made, if necessary to:

(i) conform to the accounting principles generally accepted in the United States for the preparation of such statements, except as modified by this regulation;

(ii) conform to the tax accounting standards as required under Division 2 Part 11 of the California Revenue and Taxation Code; and

(iii) eliminate unrealized gain and losses resulting from the restatement or revaluation of assets or liabilities to reflect changes or fluctuations in currency values.

(B) Business and nonbusiness income as determined under California law shall be identified and segregated. For definitions, rules and examples for determining business and nonbusiness income, see generally Regulation 25120.

(C) Nonbusiness income shall be allocated to specific states pursuant to the provisions of Section 25124 to 25127, inclusive of the Revenue and Taxation Code.

(D) Business income shall be included in the combined report prepared for each unitary business and will be apportioned on the basis of the appropriate formula for each business.

(E) Income from California sources shall be expressed in dollars in accordance with subsection (b)(4) and the taxes computed accordingly.

(3) For purposes of subsections (b)(1)(B), (b)(1)(C), and (b)(2)(A), the following rules shall apply:

(A) Accounting adjustments to be made to conform profit and loss statements to those utilized in the United States —

(i) Include but are not limited to the following:

(I) Clear reflection of income. Any accounting practice designed for purposes other than the clear reflection on a current basis of income and expense for the taxable year shall not be given effect. For example, an adjustment shall be required where an allocation is made to an arbitrary reserve out of current income.

(II) Physical assets, depreciation, etc. All physical assets, including inventory when reflected at cost, shall be taken into account at historical cost computed either for individual assets or groups of similar assets. The historical cost of such an asset shall not reflect any appreciation or depreciation in its value or in the relative value of the currency in which its cost was incurred. Depreciation, depletion, and amortization allowances shall be based on the historical cost of the underlying asset, and no effect shall be given to any such allowance determined on the basis of a factor other than historical cost.

(III) Valuation of assets and liabilities. Any accounting practice which results in the systematic undervaluation of assets or overvaluation of liabilities shall not be given effect, even though expressly permitted or required under foreign law, except to the extent allowable under subsection (b)(3)(B). For example, an adjustment shall be required where inventory is written down below market value.

(IV) Income equalization. Income and expense shall be taken into account without regard to equalization over more than one accounting period; and any equalization reserve or similar provision affecting income or expense shall not be given effect, even though expressly permitted or required under foreign law.

(ii) Currency gains or losses on closed transaction are includible, but no adjustments shall be made, or otherwise reflected, for unrealized gains or losses resulting from the restatement or revaluation of assets or liabilities to reflect changes or fluctuations in currency values. A closed transaction is one where any foreign exchange position taken by a corporation has been terminated by exchanging the foreign currency for the currency in which the individual corporation maintains its books and records and normally conducts its business affairs. In the case of a borrowing in a foreign currency, the transaction shall not be deemed closed until repayment is made.

(B) The tax accounting adjustments to be made shall include, but are not limited to, the following:

(i) Accounting methods. The method of accounting shall reflect the provisions of Section 24651 of the Revenue and Taxation Code and the regulations thereunder.

(ii) Inventories. Inventories shall be taken into account in accordance with the provisions of Section 24701 through 24706 of the Revenue and Taxation Code and the regulations thereunder, except Regulation 24702 — 24706(b)(5).

(iii) Depreciation, depletion, and amortization. Depreciation, depletion, and amortization are to be computed in accordance with California law.

(iv) Elections.

(I) Elections required to be made for purposes of determining income under Division 2 Part 11 of the Revenue and Taxation Code of all California reporting entities shall be made in accordance with applicable provisions of such law and the regulations adopted pursuant thereto.

(II) Elections required to be made for purposes of determining income under Division 2 Part 11 of the Revenue and Taxation Code for entities which are not subject to taxation by California but are required to be included in the combined report for the unitary business shall be made by agreement of all entities required to report to California in accordance with applicable provisions of such law and the regulations adopted pursuant thereto. If agreement cannot be reached, such income shall be reported on the basis of United States generally accepted accounting principles.

(C) No adjustment shall be required under subsections (b)(3)(A) and (b)(3)(B) unless it is material. Whether an adjustment is material depends upon the facts and circumstances of the particular case, including the amount of the adjustment, its size relative to the general level of the corporation's total assets and annual profit or loss, the consistency with which the practice has been applied, and whether the item to which the adjustment relates is of a recurring or a nonrecurring nature.

(4) For purposes of determining income, necessary translations shall be made at the following exchange rates:

(A) Depreciation, depletion or amortization shall be translated at the appropriate exchange rate for the translation period in which the historical cost of the underlying asset was incurred.

(B) All other items shall be translated at either the end-of-year exchange rate or at the simple average exchange rate for the translation period. Income repatriated during the year shall be translated at the exchange rate at date of repatriation. It is

presumed that the translation rate used in preparing the consolidated profit and loss statement for financial reporting purposes is proper absent a showing that some other method is appropriate.

A change from end-of-year rates or average rates may not be made without the permission of and on such conditions as the Franchise Tax Board may prescribe.

(C) Computation of Factors. In computing the formula factors, the following rules shall apply:

(1) Property Factor.

(A) Fixed assets shall be valued at original cost as defined in Reg. 25130(a) and translated at the exchange rate as of the date of acquisition.

(B) Rented property, capitalized at eight times its annual rental rate, shall be translated at the simple average of the beginning and end-of-year exchange rate.

(C) Inventories shall be valued at original cost and shall be translated at the exchange rate as of the date of acquisition.

(D) For purposes of calculating the property factor of financial corporations, financial assets are translated at the year-end rate and are defined as assets reflecting a fixed amount of currency, such as cash on hand, bank deposits, and loans and accounts receivable. Securities held, or reasonably expected to be held, for less than six months shall be translated at year-end rates. If a security is held, or reasonably expected to be held, for more than six months, it shall be translated at the appropriate exchange rate for the translation period in which the historical cost of the asset is determined.

(E) The property factor shall be computed in the currency of the parent company unless the taxpayer requests and the Franchise Tax Board determines that computing the factor in dollars or any other currency fairly reflects the taxpayer's activities in California.

(2) Payroll and Receipts Factors.

(A) Translation shall be made at the simple average of the beginning and end-of-year exchange rates unless there is a substantial fluctuation, as described in subsection (d)(2).

(B) Where the value of the foreign currency does fluctuate substantially, as described in subsection (d)(2) the exchange rate appropriate to that period shall be either (1) a simple average of the month-end rates, or (2) a weighted average taking into account the volume of transactions (reflected by the amount being translated) for the calendar months ending with or within that period.

(C) In computing the payroll and receipts factors, translation shall be made into the parent company's currency in order to properly determine the percentage factor to be used unless the taxpayer requests and the Franchise Tax Board determines that computing the factors in dollars or any other currency fairly reflects the taxpayer's activities in California.

(d) Exchange Rates.

(1) For purposes of preparing combined reports, exchange rates may be derived from any source which is demonstrated to the satisfaction of the Franchise Tax Board to reflect actual transactions conducted in a free market and involving representative amounts. In the absence of such demonstration, the exchange rates taken into account in computation of the earnings and profits of the foreign corporation shall be determined by reference to the free market rate set forth in the pertinent monthly issues of *International Financial Statistics* or successor publications of the International Monetary Fund.

(2) In general, the extent of fluctuation is substantial if the closing rate for any calendar month ending within the period varies by more than 10 percent from the closing rate for any preceding calendar month ending within the period.

(e) Application of Regulation.

(1) In computing the income and any of the factors required for a combined report, the Franchise Tax Board shall consider the

effort and expense required to obtain the necessary information. In appropriate cases, such as when the necessary data cannot be developed from financial records maintained in the regular course of business, the Franchise Tax Board may accept reasonable approximations.

(2) A taxpayer may request an advance determination under subsections (b)(2), (b)(3)(C), (c)(1), (d)(1) or any other provision of this regulation by submitting a determination request to the Legal Division of the Franchise Tax Board. Such a determination shall be made on an individual basis and shall be limited to the particular facts or circumstances set forth in the determination request. The facts and circumstances upon which a determination is made remain subject to review. Failure to request or to obtain a favorable advance determination will not preclude consideration of requested variances in subsequent procedures.

Note: Authority cited: Section 26422, Revenue and Taxation Code.
Reference: Section 25137, Revenue and Taxation Code.

(Applicable for income years beginning after December 31, 1972; amended effective March 27, 1985.)

EXHIBIT 13

COSTS OF COMPLIANCE FOR CALIFORNIA WORLDWIDE COMBINED REPORT

SET-UP	
Analysis of information available and information needed	$ 255,000
Design of tax package for subsidiary and branches	85,000
Implementation and training	340,000
Create computer program and information base:	
Fixed Assets	1,615,000
Securities	680,000
Leased assets	680,000
Bad debts	170,000
Other items (e.g. rentals, reserves, intangible assets, non-performing loans)	850,000
TOTAL STAFF COSTS	$4,675,000
Cost of systems set-up and processing	3,000,000
TOTAL PROJECTED SET-UP COSTS	$7,675,000

ANNUAL COMPLIANCE	
Identification and segregation of business and non-business income under California law	$ 340,000
Fixed assets	425,000
Securities	255,000
Leased assets	255,000
Bad debts	85,000
Other differences between book and tax accounting (see Exhibit 6)	680,000
TOTAL STAFF COSTS	$2,040,000
Cost of systems processing	1,000,000
TOTAL PROJECTED ANNUAL COMPLIANCE COSTS	$3,040,000

MAINTENANCE AND TRAINING	
Monitoring tax and accounting changes	$ 85,000
Updating tax package and systems	255,000
Annual training for changes and new personnel	85,000
TOTAL STAFF COSTS	$ 425,000
Cost of systems processing	300,000
TOTAL PROJECTED ANNUAL MAINTENANCE AND TRAINING COSTS	$ 725,000

EXHIBIT 14

COSTS OF COMPLIANCE FOR CALIFORNIA WORLDWIDE COMBINED REPORT

Barclays Bank International Limited (BBI) and Barclays Bank of California (Barcal) are members of the Barclays Group, a United Kingdom based group of corporations headed by Barclays PLC and composed of approximately 300 subsidiaries, including Barcal and BBI (BBI is now Barclays Bank PLC as a result of a merger in 1985. However, to avoid confusion, references will be made to BBI). The term "Barclays Group" is used in this report to refer to the aforementioned parent company Barclays PLC and all its subsidiaries, direct and indirect.

The Barclays Group presently has offices in over 80 countries. BBI itself operates directly (through branches or agencies) in over 31 countries. Although the general business of the Barclays Group might be described as banking, the Barclays Group also includes entities involved in insurance, merchant banking, factoring, mortgage banking, trust company operations, unit trust (mutual funds) management, consumer finance and leasing activities.

The California Revenue and Taxation Code and regulations, and particularly Reg. Section 25137-6, set forth the requirements for filing California combined reports that include foreign company operations. If a taxpayer is involved in a unitary business with related entities, it must file a combined report setting forth the aggregate worldwide business income and non-business income of those entities which comprise the unitary business. The California share of the worldwide income is determined by first apportioning to California a percentage of the business income based upon:

$$\frac{\frac{\text{CA. Payroll}}{\text{WW Payroll}} + \frac{\text{CA. Property}}{\text{WW Property}} + \frac{\text{CA. Receipts}}{\text{W Receipts}}}{3}$$

The nonbusiness income is allocated in accordance with the rules set forth in the Revenue and Taxation Code and regulations.

To prepare the combined report, the information required under the Code and regulations for the filing of a worldwide combined return, and specifically the provisions of Reg. Section 25137-6, the information centrally collected by the Barclays Group and the procedures presently utilized to collect information within the Barclays Group were reviewed. The following costs, set forth in greater detail on Exhibit 1, would have to be incurred to comply with the California worldwide reporting requirements. These costs would be incurred exclusively for purposes of such compliance and would not otherwise be incurred by the Barclays Group for any other purpose:

Initial Set Up Costs	$7,675,000
Annual Compliance Costs	$3,040,000
Maintenance and Training	$ 725,000

1. *Information Presently Collected By the Barclays Group*

The Barclays Group presently collects certain financial information for the purposes of filing its annual report to its shareholders.

The information presented in the annual report is rounded to the millions (000,000) of U.K. pounds sterling.

Summary information is collected at various levels within the Barclays Group and is forwarded to the Chief Accountant's Office for purposes of the preparation of the annual report. The Barclays Group does not maintain central books and records of the various subsidiaries and does not require non-U.K. subsidiaries to maintain accounts in sterling. Only those entities operating in the U.S. and the Virgin Islands maintain their accounts in U.S. dollars.

The Barclays Group collects information on the branch operations on Standard Accounting Schedules, Branches, and on subsidiaries on Standard Accounting Schedules, Subsidiaries. The subsidiary information is rounded to the thousands (000) and the schedules are in summary form. Copies of these forms are attached as Exhibits 2 and 3, respectively.

The information centrally collected and available is not sufficient to properly prepare a California combined report including

foreign company operations. In order to properly prepare a tax return, a taxpayer may not rely solely on the information contained in its financial statements or make a few adjustments to the income on its profit and loss statement to arrive at taxable income. Financial accounting and tax accounting differ in that what is considered acceptable for one (such as rounding to the thousands or even millions of pounds as set forth in the taxpayer's annual report or the timing, treatment and availability of income or deductions) will not be acceptable for the other. The accepted procedure to arrive at taxable income is to identify those areas where tax accounting standards differ from generally accepted accounting principles and then go directly to the detailed source information (e.g., the general ledger, the property listing, the payroll records, the employee expense reports, etc.) to calculate the correct amount of income or deduction to be used for tax purposes. For an indication of the areas that must be considered in preparing a U.S. income tax return, see an attached checklist for corporate taxpayers (Exhibit 4) and an aditional tax checklist applicable to commercial banks (Exhibit 5). Some of the areas where tax and book calculations are likely to differ under United States principles are set forth in Exhibit 6.

However, the Barclays Group information is collected in accordance with the United Kingdom standard accounting practices in order to file an annual report in the United Kingdom. No analysis has been done on the differences between California, or even the United States, tax accounting rules and the financial accounting methods of the United Kingdom.

Except for the California tax, the Barclays Group would have no reason to ascertain any such differences. A group of corporations, with its home office in a foreign country and with subsidiaries or branch operations in the United States, is subject to federal income tax only on income arising from its activities in the United States. The United States has adopted, both in treaties and in its statutes and regulations, the internationally recognized and used standard of separate accounting. As a result, a foreign-based taxpayer does not provide information on its non-U.S. operations or on the results of its subsidiaries operating exclusively outside the United States to the federal taxing authorities. Foreign-based

taxpayers have, therefore, not been required to establish a procedure which would gather information necessary to adjust non-U.S. operating results to U.S. tax accounting standards. It is only for the purposes of filing the California worldwide combined report that a foreign-based corporate group must accumulate information from all of its operations and subsidiaries throughout the world to permit calculation of income based on California tax accounting standards. In the case of the Barclays Group with approximately 5,000 offices and branches and subsidiaries in over 60 countries and currencies, the accumulation of specific information to permit reporting on the California tax accounting basis requires a commitment of resources to the task which would not be required for any other taxing jurisdiction. In other words, the costs of compliance with the California worldwide combined reporting method are incurred solely because of the California tax rules and would not be incurred if these rules did not apply beyond United States boundaries.

2. *System To Comply With California Requirements*

A proper system for compliance with the California combined reporting requirements has three cost components: (a) set-up, (b) annual compliance, and (c) maintenence of the system.

(a) *Set-Up*

The information presently collected and the system to collect such information are not oriented to the collection of tax information.

To create a proper system, it is necessary (i) to analyze the differences between California tax accounting standards and U.S. and U.K. generally accepted accounting principles, (ii) to determine what information is needed to calculate the adjustments from U.K. accounting principles to tax accounting standards, and (iii) to analyze what useful information might be available centrally and what information would be required from each of the operations and subsidiaries.

Next a "tax package," understandable by personnel at locations throughout the world and easily processed by computer, would need to be designed to collect the information. Computer pro-

grams would have to be designed to take the information provided by the responding locations and perform the necessary calculations to arrive at the adjustments for tax accounting purposes.

Finally, an initial data base of information essential to all future calculations for the California worldwide combined report would be created. This would include information regarding fixed assets, securities, leased assets (both by the Barclays Group and to customers), reserves and historical information for the tax bad debt deduction. For example, to comply with the requirements of Reg. Section 25137-6, the information needed on fixed assets would include the date of acquisition, the cost at date of acquisition in local currency, the exchange rate that existed at the date of acquisition between local currency and U.K. pounds sterling, the expected salvage value, the type of asset so that the asset can be placed in the proper depreciation classification for California tax purposes, and any assets which may not be currently recorded on the financial statements (e.g., assets which had been fully depreciated for financial purposes).

(b) *Annual Compliance*

Each year the tax package which had been developed as part of the set-up procedures would be sent to all operations and subsidiaries throughout the world. Central staff would review the information received for correctness and completeness, and, in those instances where questions arise, follow up with the locations. The separate location information would need to be combined into a useful format and this information would ultimately be used to compute the adjustments needed to report results under California tax accounting standards.

Specific detailed information would have to be requested and accumulated for each difference between the financial information and tax accounting information which had been identified in the original analysis. The level of an adjustment cannot be known without obtaining the detailed information for each identified book versus tax difference.

Business and nonbusiness income would have to be identified for allocations.

(c) *Maintenance*

The Barclays Groups would also be required to monitor changes to U.S. and California tax law and changes to U.S. and U.K. generally accepted accounting principles. Changes in the Barclays Group's activities and structures would need to be monitored to determine whether an entity was includible or excludable from the unitary group or whether there were separate unitary businesses. All changes would have to be incorporated into revisions to the tax package and the processing systems.

EXHIBIT 15

ACCOUNTING STEPS REQUIRED UNDER 18 CALIFORNIA ADMIN. CODE 25137-6

Method One (Subsection (3)(b)(1))

Foreign-Multinational Corporation	Domestic-Multinational Corporation
Preliminary Step **Step A** Profit & Loss Statement Prepared each Foreign Branch or Corp.	
Prepared in normal course.	Prepared in normal course.
Step B Adjust P&L to U.S. Generally Accepted Practices (GAAP)	
Individual P&Ls must be adjusted from accounting practaices of locality where kept.	Prepared in normal course.
Step C Adjust to Tax Accounting Standard of California	
Must be done. Must have knowledge of financial statement book differences from California Rules and then convert the P&L to California taxable income.	Prepared in normal course. Footnote disclosure is required for the amount of current liability for state taxes.
Step D Profit & Loss each Branch or Corp. to Currency of Parent	
Prepared in normal course.	Prepared in normal course.
Step E Business & Non-business Income Segregated	
Must be done.	Must be done.

Foreign-Multinational Corporation	Domestic-Multinational Corporation
Step F Allocations of Non-business Income	
Must be done.	Must be done.
Step G Income Apportioned on Basis of Formula	
Must be done. Must have knowledge of what apportionment factors are.	Prepared in normal course.
Step H Convert Local Currency to Dollars	
Must be done.	Prepared in normal course.

EXHIBIT 30A

UNITED KINGDOM VERSUS UNITARY TAXATION

Statement of the United Kingdom before the United States Treasury Working Group on Worldwide Unitary Taxation*

Summary of principal points

A. Her Majesty's Government is opposed to the application of the unitary method of state taxation on a worldwide reporting basis.

B. The worldwide unitary method of state taxation is contrary to well established international principles and practice of taxation, and imposes unreasonable tax and administrative burdens on multinational corporate groups doing business throughout the world.

C. Unitary taxation is already damaging commercial and economic relations between the US and the UK and other countries. If it continues, the damage to international trading relations will become more serious. If unitary taxation spreads, the scale of the worldwide damage will be further increased.

D. In particular for UK companies unitary tax imposes significant additional burdens on both the companies and their shareholders. First it produces anomalous tax liabilities, which may be considerately larger than those calculated on the internationally-accepted arm's length basis. Second the requirements of the method involve additional compliance costs. In addition the uncertainty generated by the unitary method has disruptive effects on UK corporations' business activities and industrial investment.

E. As long as the worldwide unitary method persists, it will be impossible to achieve the essential economic objectives of providing a consistent and coherent tax framework for international

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trade and investment. Moreover, the damage to international trade and investment would be greatly increased if foreign Governments responded by imposing retaliatory measures or introducing unitary systems of their own.

I. INTRODUCTION

1. Almost two years ago, the United States Government advised the Supreme Court in its brief in the *Chicago Bridge & Iron Co.* case, that "the imposition of [a state tax] on the apportioned combined worldwide business income of a unitary group of related corporations impairs federal uniformity in an area where such uniformity is essential". That explicit pronouncement of United States policy is equally appropriate for today. Indeed, since that brief was filed, the threat to international business relations posed by the worldwide unitary method of state taxation has assumed even greater magnitude. At present 11 states employ the worldwide combined reporting system, namely Florida, California, Massachusetts, Oregon, Alaska, Idaho, Colorado, Montana, New Mexico, North Dakota and Utah. Approximately 70 per cent of the direct foreign investment in the United States comes from Western Europe. Hence, the burden of the unitary worldwide combined reporting system falls particularly heavily on European based corporations.

2. It is therefore hardly surprising that the unitary tax issue has been the subject of repeated diplomatic protests from other governments since 1979. On August 1, 1983, the 10 governments of the European Community delivered a diplomatic note to the United States Government renewing their objections to the international application of the unitary tax. Similar objections were expressed by the Japanese Government on August 11, the Netherlands Government on August 17, and the Canadian Government on August 23. Earlier protests against unitary taxation by these governments have been well publicised.

3. The United Kingdom has an interest even stronger than that of other Governments since the United Kingdom direct investment in the United States is greater than that of any other country. By 1982 the cumulative total of United Kingdom investment in the United States was $23.334 billion which accounted

for 23% of the foreign direct investment in the United States. Any measure which inhibits investment by British business in the United States is clearly to the detriment of both countries. Her Majesty's Government believes that unitary taxation already has a damaging effect on the business relations between the two countries and that the damage will become very serious if the issue is not speedily resovled.

4. The unitary method of taxation is wholly contrary to the agreed international method of attributing the profits of multinational enterprises between the countries in which they operate. This is the arm's-length method which seeks to ensure that profits of such enterprises are allocated in such a manner that each country is able to claim tax on the profits — and no more and no less than the profits — actually earned in that country. If all countries use the same arm's-length basis in determining the profits, then double taxation should be avoided through the international net-work of double taxation agreements.

5. Unitary taxation is incompatible with this internationally agreed method. It uses a formula to determine what sum shall be charged and, as practised in the States, it may include profits brought into charge elsewhere on the arm's-length basis. If unitary taxation were practised worldwide and every national state could use an identical formula for determining its share of the profits of a multinational enterprise then agreement might be reached internationally on such a basis which would eliminate double taxation. It is, however, the case that over the last 40 years or more the international community has devised and refined the arm's-length method for international use. It is in this context of worldwide agreement about the method of attributing profits to multinational companies that the use of a different method by some states of the United States causes a distortion which makes it internationally unacceptable.

6. It it for these reasons that Her Majesty's Government has consistently urged that action be taken to prevent the application of unitary taxation to United Kingdom businesses. It sought to do so when negotiating the current United Kingdom/United States Double Taxation Agreement: but when in 1979, the United States Senate ratified the Treaty it attached a reservation against this

provision in Article 9(4). That Article in its original form would have prevented the United States Government and the individual states from applying the unitary method to United Kingdom corporate groups which have subsidiary companies in the United States. In its final form, the Article applied only for purposes of the United States Federal tax, which does not employ the unitary method. At the time the United Kingdom, with the approval of Parliament, ratified the amended Treaty and accepted the Senate reservation against Article 9(4), Her Majesty's Government was given to understand that the Government of the United States would use its best endeavours to eliminate the application of the unitary method of taxation on a worldwide basis. Nevertheless, since then more states have adopted the worldwide unitary approach.

7. Attempts have been made concurrently to secure a solution through the United States Supreme courts without success. Last June the United States Supreme Court ruled in *Container Corporation v. Franchise Tax Board*, that the California worldwide unitary tax method did not violate the Foreign Commerce Clause of the United States Constitution as applied to a United States parent corporation and its foreign subsidiaires. In so holding, the Court specifically reserved the question of the constitutionality of combined apportionment with respect to state taxation of domestic corporations with foreign parents or foreign corporations with either foreign parents or foreign subsidiaries.

8. In Her Majesty's Government view, the Court's decision in *Container Corporation* was an unfortunate setback that derived, in large measure, from the confusion caused by the failure of the United States Government to reaffirm the position taken in its original brief in the *Chicago Bridge* case, to which we have referred. In considering whether the California tax impaired federal uniformity and the conduct of United States foreign relations, the Court observed that the federal government's failure to file an amicus brief in the *Container* case suggested that "the foreign policy of the United States is not seriously threatened by California's decision to apply the unitary business concept and formula apportionment . . ." Hence, Her Majesty's Government believes that the outcome of the Court's sharply divided (5-3) decision could well have been different had the federal govern-

ment clearly restated what all parties originally understood to be its position.

9. Moreover, the likelihood of an early resolution of the applicability of the unitary method to the foreign parent corporation case reserved by the Supreme Court is very much in doubt. Attempts are being made to have the matter heard but two courts of appeal have dismissed suits by foreign corporations against the California Franchise Tax Board on the ground that those foreign entities lack "standing" to contest the tax assessments that are nominally addressed to their domestic subsidiaries. On the other hand, as domestic corporations, the subsidiaries cannot invoke the treaty provisions that are at the heart of the claim that the unitary method impairs the conduct of foreign relations. Hence, these court rulings render rights conferred by treaties unenforceable by the very entities those provisions were negotiated to protect companies of one treaty part engaged in this way in the territory of the other treaty party.

10. The denial of standing to raise claims under the United States Constitution will leave foreign parent companies which in fact bear the economic burden of double taxation caused by the unitary method unable to challenge the lawfulness of that burden. This may not be "taxation without representation" as it is usually understood. But it does amount to taxation without the right to be heard, in that a levy whose constitutionality is at issue cannot be challenged by a party directly affected by it. Reciprocally narrow rulings by foreign courts would weaken the ability of the United States companies to obtain judicial protection for their investments abroad.

11. In sum, the failure of both the treaty making process and federal litigation to resolve the validity of the worldwide unitary method makes it imperative that a comprehensive solution be reached as soon as practicable. It is Her Majesty's Government's view that this method is incompatible with the internationally accepted regime for taxing the profits of multinational enterprises.

II. CRITERIA FOR JUDGING A TAX SYSTEM

12. Any tax system should be judged on whether it is capable of being administered equitably, produces certainty and efficiency, and whether it is capable of simple operation. The effects of applying unitary tax on a worldwide basis are both *inequitable and uncertain*. Moreover it is *far from simple* for the companies concerned, since it requires a restatement in US terms of the income and formula factors for each component part of a group operating worldwide. These effects in turn constitute an element of *tax induced inefficiency* in the world economy, which will inevitably distort trade patterns and inhibit business decisions.

Application to differing economic circumstances

13. These adverse effects can be traced to particular aspects of applying the unitary basis to the conditions and circumstances which exist today. First, when applied on a worldwide basis, the unitary system is of necessity operating in economic conditions which are far from homogeneous. The system works by combining the income of several related corporations engaged in a "unitary" business. Income is then allocated to the taxing state by multiplying the total income of the enterprise by a percentage comprised of the average of the ratios of instate property, payroll and sales to total property, payroll and sales. The precise formula varies from one State to another.

14. The theory underlying this "unitary" approach is that a dollar of payroll or property spent or a dollar of sales made in one tax jurisdiction produces roughly the same amount of taxable income as a dollar so spent or sales made in another tax jurisdiction. This theory manifestly falls down when applied to two (or more) countries whose economic circumstances are very different. For example, in a developing country property and payroll costs may be very low, relative to those in the United States. On the other hand profits will probably be higher to reflect the risks of expropriation, currency exchange limitations, or other factors. Applying the unitary basis to a group operating both in the USA and a developing country will thus result in a reallocation of group's income from the developing country to the USA. Quite apart from the implications for the group itself (which are

discussed in more detail below), it must be open to question whether this represents an equitable division of world resources.

Incompatibility with arm's length basis

15. Second, because international trade relations operate on an entirely different (i.e. arm's length) basis, the worldwide application of the unitary system produces results which are at best anomalous and at worst give rise to serious inequities. In sharp contrast to the unitary method (see above), the arm's length method requires the income of each corporation to be computed on a separate accounting basis under the assumption that each member of a corporate group must deal with the other members as if they were wholly separate entities owned by unrelated interests. This method has now been recommended by both the OECD and UN model treaty and enshrined in a worldwide network of bilateral treaties to prevent double taxation, including those treaties to which the USA is a party. In addition, following the lead given by the US Federal Authorities in 1928, virtually all developed countries have now adopted the arm's length standard for preventing tax avoidance through artificially fixed inter-company prices.

16. The unitary method and the arm's length method are not compatible. Applying the unitary formula to groups which also operate in countries which work on the arm's length basis leads to cases of double taxation. It has been argued that the unitary basis does not in fact tax the foreign source income of foreign corporations related to the "unitary" company. Instead that income is merely taken into account in order to determine the net income attributable to activity within the "unitary" state. But the arithmetical results of applying a unitary formula belie this argument. The "unitary" state is in effect requiring a consolidated income tax return and subjecting to tax the income earned by foreign members of the unitary group without giving any relief for overseas tax. In other words it has extended its jurisdiction to bring into its tax net income over which other states will have exercised their priority taxing rights under the normal arm's length arrangements.

17. The element of double counting this involves can and does lead to multinational groups being taxed on more than 100 per cent of their income. This may represent an additional financial cost for the group itself, which is inequitable. Or it could lead to a diminution of the revenues flowing to any exchequer which seeks to avoid double taxation by giving credit for the "unitary" tax paid — a result which at best can be described as anomalous. These inequities and anomalies are particularly acute in the — not uncommon case — where the US company of a unitary group operates at a loss. Even though it had made no profit by any normal commercial standards, the US company would be liable for tax in respect of a portion of the worldwide profits of its foreign affiliates. In other words there would be an element of direct subsidy from the worldwide group (or foreign revenue as the case may be) to the unitary state.

Unitary basis is not uniform

18. Third the unitary basis is not — and cannot be — uniform in its application. The very concepts it uses are incapable of precise definition, at least on anything other than a very local basis. It is notable that, even amongst the various states within the USA, there are significant variations first in the criteria used for determining whether or not a particular corporation is "unitary", and second in the formula to be applied to unitary corporations. Even within an individual state it is by no means unknown for a business which has been deemed "unitary" one year to be classed as non-unitary the following year, and for the basis of calculating its tax liability to vary from one year to the next. As a result no business can be sure whether or not it will be adjudged to be "unitary" and if so, how its tax bill will be calculated. In other words the unitary basis breeds uncertainty. The problem this creates for business is heightened by the lack of any procedure analogous to that embodied in "arm's length" tax treaties for resolving disputes about the application of the rules to individual cases.

Unitary basis imposes high compliance costs

19. The fourth aspect of the unitary basis which contributes towards its damaging effects is the compliance costs it involves. It is for the companies themselves to tell the Working Group what complying with the unitary system means in practice. The UK Government would merely note that the full requirements of the system necessitate, at a minimum, the translation into US dollars of accounts maintained by related companies in a multitude of different currencies and the preparation of extra sets of accounts to meet the specific, and varying, requirements of the unitary states. And we understand that the details requested often reflect confidential data, trade secrets, or other information that cannot be made available for reasons totally unrelated to tax considerations.

20. Of more direct concern to the UK Government is the extent to which the unitary states' demands for financial information may involve investigation of the records of UK companies which are outside the USA. More often than not, the substantial majority of the records required describe business transactions that are entirely unrelated to activities within the United States. This is objectionable in principle, as well as producing excessive compliance burdens in practice.

Comparison of unitary method with arm's length method

21. By contrast, the arm's length method, though not perfect, avoids these four very real problems which inevitably arise when the unitary basis is applied worldwide. First by focussing on the amount of profit that would have been made within an individual country by independent parties dealing at arm's length, it recognises that companies operating in different economic circumstances will incur different costs and run very different risks. Second, there is of course no question of the basis being incompatible with internationally accepted methods — the arm's length basis *is* the internationally accepted method. Equally, the 'international' nature of the arm's length method helps to avoid the third problem — the lack of any uniform rules. Because it has been for so long the guiding principle of international tax, there has been time to smooth out the 'rough edges' of the arm's length

method. The countries of the world have evolved a series of internationally accepted standards which are capable of exact definition under clearly applied procedures. So the various problems identified earlier — of double taxation: of companies being liable to tax on more than 100 per cent of their income: of companies being liable to tax in respect of profits when, on normal commercial principles, they are making a loss — simply do not arise or where they do, they can be satisfactorily resolved.

22. The fourth problem, that of high compliance costs for companies, equally does not arise to anywhere near the same extent under the arm's length method. The information required in order to operate this method is, more often than not, information which companies have already had to prepare for other purposes. The use of accounts drawn up to comply with company law requirements is a good example of this.

23. Generally, therefore, when measured against the criteria for judging a tax basis the arm's length basis is on each count preferable to the worldwide unitary method. It is at once more equitable, more certain, simpler and more conducive to efficiency. Nor does there seem any good reason why it should not serve as an effective policing mechanism to protect the revenue of individual states. There is an extensive body of Treasury Regulations under Section 482 of the International Revenue Code of 1954 providing definitive guidelines governing the fiscal relationships of commonly-controlled corporations. Moreover we understand that, under long-standing accords, information gathered by the United States Treasury from Federal tax audits is continually made available to the individual States. Against this background, the majority of States have felt able to operate an arm's length system, and to apply this rule to subsidiaries of multinational group resident within their jurisdictions.

Wider consequences of the unitary system

24. Any set of rules which fails to measure up to the criteria of a good tax system must be expected to have adverse consequences which go well beyond the immediate impact of that set of rules itself. This is certainly the case with the current application, by several US States, of the unitary system on a worldwide basis.

25. First there is now evidence that it is inhibiting trade relations and distorting investment patterns. In the light of the inequities, anomalies and uncertainties generated by the tax rules, foreign corporations are re-appraising the benefits and burdens of conducting business within a unitary state. The recent decision by the London Chamber of Commerce to cancel its mission to Florida on account of Florida's adoption of the worldwide unitary basis is a good example of this.

26. Furthermore, the spread of unitary taxation amongst the various States can only serve to undermine the very strong position that the United States has adopted in OECD and elsewhere for the liberalisation of international investment flows. The position was restated only a few weeks ago by President Reagan himself in his 9 September Statement on US policy towards international investment. The continued imposition of unitary taxation is incompatible with this stance.

27. These adverse consequences for worldwide trade and investment would be even worse if other countries respond to the States' application of unitary tax by taking retaliatory measures or introducing unitary systems of their own. In particular the States' operation of the worldwide unitary basis, and the US Federal Government's failure to prohibit this system, may well serve as an example which other countries will soon choose to follow. In particular some developing countries may feel that the system has its attractions for them. If such countries adopt unitary tax, they would be unlikely to follow the three factor formula used, for example, in California. The very different economic conditions which prevail in the developing world would naturally incline them to develop or emphasise factors which allocate a greater proportion of income to the developing country. They might for example focus simply on sales.

28. The effects of other countries taking retaliatory measures, or unitary tax spreading outside the United States, will be keenly felt by the United Kingdom. This is because the UK invests on a substantial scale in foreign countries in both the developed and developing world. But if the UK is a substantial investor in foreign countries, the United States is a much larger one. So the adverse impact on the United States must be expected to be much

greater. As things stand at present the economic burden this imposes will, in large part, fall on the United States Federal Government. Because the United States' Internal Revenue Code allows a credit against United States taxes for taxes paid to a foreign country (subject to certain limitations), any increase in foreign taxes could be offset dollar for dollar by a reduction in United States taxes.

III. CONCLUSION

29. In this paper the UK Government has analysed the worldwide unitary system by reference to the universally-accepted criteria of a good tax system — equity, certainty, simplicity and the promotion of economic efficiency. It has demonstrated that, when applied in the present international context, the worldwide unitary method inevitably produces results which are inequitable and uncertain. The method involves additional compliance costs for companies. Furthermore it is in the United Kingdom Government's view objectionable in principle that the method can require the disclosure of the records of companies outside the USA, particularly as these will often apply to transactions entirely unrelated to activities within the United States.

30. If the worldwide unitary system is allowed to persist it will hamper rather than promote economic efficiency distorting investment patterns and inhibiting trade throughout the world. It makes it impossible to achieve the essential objective of providing a consistent and coherent international tax framework for trade and investment. This framework is particularly crucial at the present juncture in the development of the world economy, when businesses are seeking profits throughout the world without regard to national boundaries. The narrow economic standpoint of the unitary system is incompatible with the harmonious relationship that is the goal of our governments, to the benefit of the American and British people alike.

EXHIBIT 30C

Paper Submitted by the Government of Canada to the United States Treasury Working Group on Unitary Tax

The purpose of this paper is to express the concerns of the Government of Canada about the increasing use within the United States of America of "unitary" methods of taxation on the basis of combined worldwide apportionment. Such methods tax the combined worldwide incomes of a domestic subsidiary and its foreign parent, in conflict with the "arm's length" method used by the United States Government and accepted internationally.

Our concern is based principally on the incompatibility of these two methods of taxation which often results in multiple taxation that cannot be relieved through existing taxation conventions. This unrelieved multiple taxation combined with the administrative burden of complying with unitary tax requirements imposes a continuing obstacle to the flow of international trade and investment.

1. *The Incompatibility of Combined Worldwide Apportionment with Generally Accepted Prnciples [sic] of Arm's Length Income Allocation for Tax Purposes Often Results in Multiple Taxation.*

Under the arm's length approach, broadly speaking, every corporation is subject to tax only by the jurisdictions in which it operates and only on that portion of its business attributable to the business carried on in that jurisdiction. Profits are subsequently taxable when distributed on dividends in those jurisdictions where the dividends are received for tax purposes. Combined worldwide apportionment, in contrast, combines the profits of admittedly related but separate entities and taxes them on the basis of an arbitrary formula that can vary from State to State. Separate entities, dividend flows and sources of profitable activity are ignored under combined worldwide apportionment.

The arm's length approach is clearly the internationally accepted norm for allocating income for tax purposes. This approach is in accordance with the model conventions for the avoidance of doubt taxation developed by the Organization for

Economic Cooperation and Development (OECD)[1] and the United Nations, both of which *expressly rejected formula apportionment* in favor of arm's length allocation.[2] These principles have been adopted by the nations of the world, (including the USA) in their double taxation treaties.[3]

The ramifications of using an incompatible system are significant. Most large multinational enterprises have profitable as well as less profitable (and some unprofitable) activities. Under the arm's length system, the profitable activities are subject to taxes where profits are made, and the less profitable or unprofitable ones pay less or no taxes in the jurisdictions where they are carried on. Combined worldwide apportionment, however, unrealistically implies that individual entities of the multinational enterprise have the same level of profitability. Only in the rare instance where the very different assumptions underlying both systems yield the same result are they consistent with each other. Combined worldwide apportionment methods tax worldwide, pre-tax income calculated on the worldwide basis. These methods override the intent of local tax incentives in third countries, including accelerated depreciation and ignore local tax payments which are often high.

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[1]The Organization for Economic Cooperation and Development was created in December 1960 to promote specified policies. The members of O.E.C.D. are Australia, Austria, Belgium, Canada, Denmark, Finland, France, Germany, Greece, Iceland, Ireland, Italy, Japan, Luxembourg, Netherlands, New Zealand, Norway, Portugal, Spain, Sweden, Switzerland, Turkey, United Kingdom and the United States of America.

[2]*See* United Nations Model Double Taxation Convention Between Developed and Developing Countries, arts. 5(8), 7(2), 9(1), U.N. doc, ST/WSA/102 (1980); Report of the OECD Comm. on Fiscal Affairs, Model Double Taxation Convention on Income and on Capital, arts. 5(7), 7(2), 9(1) (1977).

[3]*See, e.g.*, U.S. Treasury Department's Model Income Tax Treaty of June 16, 1981, arts. 5(7), 7(2), 9(1), I CCH Tax Treaties 158.

2. *Multiple Taxation Brought about by the Application of Combined Worldwide Apportionment Methods is Unrelieved by Existing Double Taxation Conventions.*

(a) International Efforts Towards the Elimination of Multiple Taxation

The increasing economic interdependence of western developed nations in the post-war period and the economic co-operation established among them has greatly increased the importance of preventing international multiple taxation. This need was recognised by the OECD which produced a "Draft Double Taxation Convention on Income and Capital" in 1963.

This Draft Convention has had wide repercussions. OECD member countries (including the USA) have largely conformed to it when concluding or revising bilateral double taxation conventions. More than 200 bilateral conventions for the avoidance of double taxation with respect to taxes on income and on capital have been concluded between OECD member countries. As a result, OECD member countries have achieved a considerable degree of harmonization between their bilateral conventions in the benefit of both taxpayers and national administrations and have thereby established a framework for understanding and cooperation on taxation matters which has contributed to the enormous growth of trade and investment since 1945.

Lastly, the impact of the Draft Convention of 1963 and the revised Model Convention approved in 1977 has extended outside the OECD area; it has been used as a basic document of reference in negotiations between member and non-member countries and even between non-member countries, as well as in the work of other worldwide or regional international organizations in the field of double taxation and related problems.

(b) Canada the USA Double Taxation Conventions

Neither Canadian[4] or U.S.[5] Double Taxation Conventions bind the governments of Canadian provinces or U.S. states. However, in Canada, in the case of the provinces with which the Government of Canada has a tax collection agreement, (all provinces except Quebec, plus Alberta and Ontario for corporation tax) the modifications made under bilateral double taxation conventions to the federal tax base on which provncial [sic] income taxes are calculated also apply to provincial income taxes. In addition, it has been the practice that Alberta and Ontario (for corporation tax) and Quebec abide by the rules set out in bilateral double taxation conventions.

By contrast U.S. states using combined worldwide apportionment do not utilize the provisions of existing U.S. double taxation conventions even on a voluntary basis. This is because multiple taxation caused by the application of this method occurs because it uses entirely different principles for deciding where income is earned. The multiple taxation produced can only be resolved if one tax method is required to give way to the other.[6]

Double taxation conventions were thought to be the logical instruments for dealing with the multiple taxation caused by combined worldwide apportionment. Canada attempted to deal with unitary tax practices during the lengthy negotiations which led to the signing of a new Canada-USA Double Taxation Convention in 1980 (not yet in force). Canada was unsuccessful as it was understood that the Senate of the United States had not previously consented to any limitation on the taxing jurisdiction of

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[4]As of November 30, 1983 Canada had 32 Double Taxation Conventions in force, 12 new or revised Conventions signed or about to be signed and another 28 new or revised Conventions under negotiation.

[5]As of January 1, 1983 the USA had Double Taxation Conventions in force with approximately 40 nations.

[6]While it is true that differences n [sic] the allocation of income and expenses among national tax jurisdictions employing the arms length method can also result in multiple taxation or undertaxation, these differences, being those of inconsistent applications of the same principle, can be eliminated and are susceptible to resoluiton [sic] through international negotiation and double taxation conventions.

the states by a treaty and that a provision which would have restricted the use of unitary apportionment in the case of United Kingdom corporations had previously been rejected by the Senate. However, if an acceptable provision on this subject can be devised, the United States has agreed formally to reopen discussion with Canada on this subject.[7]

(c) The Threat Posed by Combined Worldwide Apportionment to International Order in the Field of Taxation

In the opinion of the Government of Canada, the growing incidence of unresolved multiple taxation of foreign based corporations, brought about by the use of combined worldwide apportionment by major jurisdictions with the world's foremost economic power, threatens to undermine the significant progress achieved within the OECD over the last 25 years in harmonizing international taxation practices through the use of double taxation conventions. Moreover, Canada is concerned that the longer this issue remains unresolved, the greater the possibility becomes that certain foreign countries could decide to adopt variations of the unitary assessment method as a means of increasing their tax revenues.

3. *Unitary Tax Places a Significant Extra Administrative Burden on Canadian Multinational Enterprises (MNE's)*

The combined worldwide apportionment method imposes significant administrative burdens on Canadian companies doing business in those States using this method. For a foreign multinational company with subsidiaries in different countries, the submission of financial data for all of these companies to a State of the United States imposes a costly burden.

The additional administrative burden results from the uncertainty as to what foreign corporations should be included in the unitary business group (there is no standard definition), adjusting foreign financial statements to reflect State income tax laws, and

[7]*See* the exchange of letters appended to the Convention between Canada and the United States of America with respect to taxes on Income and on Capital, Washington, September 26, 1980.

translating multiple foreign currency into U.S. dollars. The uncertainty can result in lost revenue, as companies must ensure cash flow is available to cover potential taxes. In addition, substantial interest and legal costs are incurred. The administrative burden is extreme in the case of widespread multinational corporations, because accounting procedures, language and currencies vary significantly from one foreign country to another. Data may have to be obtained from all subsidiaries operating in numerous foreign countries. The information obtained from foreign subsidiaries is often in a foreign language, requiring translation. The foreign company must also perform a "foreign currency translation" with respect to foreign financial data to achieve compatability between U.S. dollars and various foreign currencies, a procedure the Comptroller General has characterized as "a laborious task."[8] As foreign subsidiaries cannot be expected to have the expertise to perform these complicated exercises, specialists have to be hired. While U.S. multinationals are required under U.S. federal law to convert financial data on effectively connected foreign subsidiaries to a U.S. tax base, such a requirement does not otherwise exist for Canadian multinationals under U.S. or Canadian tax laws and thus the extra administrative burden on Canadian multinationals is significant.

The costs of compliance are compounded by the need to prepare separate returns that conform to the varying State tax accounting requirements of the States presently employing some variant of the combined worldwide apportionment scheme. As the Comptroller General has noted, corporate taxpayers must treat the income tax returns for each State separately, and a multijurisdictional taxpayer would have to make "still more calculations for every other area where nonuniformity exists.[9] . . ."

Canadian multinationals have informed the Government of Canada that certain States hold them responsible for all revenues

[8]Report by the Comptroller General to the House Committees on Ways and Means: Key Issues Affecting State Taxation of Multinjurisdictional Corporate Income Need Resolving (GAO/CCD-82-38 (1982) at 39.

[9]*Id.* at 17.

of all foreign affiliates, even those in which they hold only a partial interest. These multinationals have also emphasized that rather than attempting to determine precisely the taxes owing, certain states prefer to negotiate the amount of tax, thus making it very difficult to even determine the precise tax liability according to law.

4. *The Extraterritorial Reach of Unitary Tax Schemes Using Combined Worldwide Apportionment May Give Rise to International Jurisdictional Conflicts.*

Unitary schemes require the local entity of the unitary enterprise to go out of State to obtain financial information held by the foreign parent or subsidiaries in third countries in order to comply with local State requirements. These schemes ignore the fact that even within unitary enterprises certain financial information is confidential, as between parent and a subsidiary and between subsidiaries, especially so when subsidiaries are not wholly owned. The situation is even more difficult when the relevant financial information reflects trade secrets or confidential information relating to the relations between foreign-based corporations and foreign governments. If the local entity is unable to comply (because of foreign law or the unavailability of the required information) the state taxing authority may arbitrarily determine the worldwide tax base and may even exact additional penalties for failure to provide the requested books and records. Such arbitrary practices are likely to evoke responses from foreign jurisdictions. If combined worldwide apportionment continues to spread, the potential for jurisdictional conflicts with foreign jurisdictions will increase proportionately.

5. *Combined Worldwide Apportionment is a Disincentive to International Investment*

Unitary tax schemes using combined worldwide apportionment, in place in fourteen U.S. States, already pose a significant disincentive to foreign direct investment in these States and impede the benefits which such investment can provide in facilitating international trade in goods and services. The possibility that the parent corporation and other subsidiaries may have to channel funds from their non-U.S. operations to pay taxes on

illusory profits created by an application of unitary tax schemes is a factor that any new investor now has to take into account. If more States adopt these unitary methods, the United States as a whole will become a less welcoming environment for investment.

The United States government in its recent international investment policy statement (September 09, 1983,) claims that "the United States has consistently welcomed foreign direct investment in this country. Such investment provides substantial benefits to the United States. Therefore, the United States fosters a domestic economic climate which is conducive to investment". The Canadian government considers that the use of unitary tax schemes is inconsistent with the above-stated U.S. international investment policy goals.

Conclusion

In summary, the inherent incompatibility of combined worldwide apportionment with the international method of income apportionment and the problems involved in its application to foreign-based multinationals serve to undermine the stability of the existing international tax framework and presents a significant obstacle to international trade and investment. The narrow focus of States applying combined worldwide apportionment is incompatible with the leadership role played by the United States of America in the world economy and with the commitment of both our countries to work towards world economic recovery. It is essential that the Working Group consider the threat that combined worldwide apportionment poses to the close economic relations enjoyed by our two countries.

EXHIBIT 30D

AUSTRALIAN SUBMISSION TO U.S. TASK FORCE ON UNITARY TAXATION

The Australian Government is concerned by the application of unitary tax to Australian companies trading in the United States and refers to the Note presented to the State Department on 7 November 1983 (a copy is attached).

The Australian Government has received representations from a number of Australian companies and business organisations regarding the unfair and onerous nature of unitary tax assessments. The views of these companies and organisations have been separately submitted to the Task Force. These representations focus on the effects of unitary tax on individual company operations and general questions of arms' length taxation principles, the administrative and cost burden of unitary assessment and the uncertainty that unitary tax introduces into company investment decisions.

The Australian Government considers that commercial relations between our countries benefit from the establishment of clear and equitable rules for commercial transactions. Under such rules commercial decisions and activities can be conducted within a predictable and stable environment. However, there is evidence that the imposition of unitary taxes by some U.S. States is detracting from this environment.

By taxing the world-wide profits of Australian companies, trading arrangements developed by these companies in the United States are subject to tax liabilities not related to the commercial standing of ventures but rather to business developed in Australia and third countries. Apart from the possibility of double taxation such companies may be disadvantaged in competing with local companies as they are subject to a higher tax burden based on world-wide income. This liability may raise the commercial costs of these companies, thus effectively discriminating against trade arrangements of Australian companies and introducing a serious degree of uncertainty over future commercial operations in the United States.

The imposition of unitary tax is particularly onerous where companies seeking to develop new opportunities in the United States are geared to sustain losses during the establishment phase in order to create a sound business base. Under the unitary method these companies, during an early stage of development, may incur tax liabilities based on the profitability of their often unrelated operations in other countries and States. Any extra burden of taxation makes the development of new opportunities a more hazardous proposition. There is a danger that the climate for investment in the United States could be affected as the threat of unitary tax assessments becomes a reality in more and more States.

The Embassy of Australia avails itself of this opportunity to renew to the Department of State the assurances of its highest consideration.

[Australian Embassy Seal]

WASHINGTON
7 November 1983

Note No: 383/83

The Embassy of Australia presents its compliments to the Department of State and has the honour to refer to the application by some States of the United States of the unitary method of taxation of the foreign income of Australian companies conducting business in the United States.

The Government of Australia sees the application of this method of taxation to the overseas income of Australian companies trading in the United States as incompatible with internationally accepted taxation principles embodied in, for example,

the model double taxation convention endorsed by the OECD in a recommendation which the United States has approved. Moreover, the same principle which the unitary tax offends is found both in the old and new taxation treaties between the Governments of Australia and the United States.

The method of unitary apportionment raises the real likelihood that economic relations between the United States and other countries such as Australia will be hindered. It creates the possibility of double taxation of income derived from Australian sources of Australian companies carrying on business in the United States. Such Australian companies will be placed in an inequitable position. They would also have to undertake onerous administrative tasks to provide the necessary information to State taxation authorities for assessment of tax liability under the world-wide apportionment formula.

As some Australian companies have already been advised they are liable for payment of unitary taxation, the Government of Australia believes the Government of the United States should take action as soon as possible to minimise the serious implications for international economic relations arising from the application of unitary tax to Australian companies. The need for action is more pressing in light of the recent Supreme Court decision in Container Corporation of America versus Californian Franchise Tax Board. In this regard the Government of Australia notes that the Supreme Court decision may lead to movement by more State Governments away from the "arms-length" tax method to the world-wide apportionment formula. It also poses the danger of other countries adopting this method of taxation and thus undermining an accepted international basis of taxation.

The Government of Australia notes the establishment of a working group charged with developing Federal policy on the unitary tax problem.

The government of Australia would appreciate receiving from the Department of State advice on the action of the Government of the United States to resolve the unitary tax problem.

It needs to be recognized that the continued application of unitary tax to income earned internationally by foreign companies

trading in the United States may lead to the introduction of similar taxation in other countries.

The Government of Australia sees the application of this method of taxation to the overseas income of Australian companies trading in the United States as incompatible with internationally accepted taxation principles embodied in, for example, the model double taxation convention endorsed by the OECD in a recommendation which the United States has approved. Moreover, the same principle which the unitary tax offends is found both in the previous and revised taxation treaties between the Governments of Australia and the United States. In this regard, the Government of Australia shares the view expressed by the Government of Japan that the proliferation of unitary tax systems greatly impairs international efforts to prevent international double taxation.

WASHINGTON, D.C.
4 January 1984

EXHIBIT 32B

United States Department of State
Washington, D.C. 20520

July 10, 1985

To Whom It May Concern:

I, Frank M. Machak, state the following:

I am Chief, Information Access and Services Division, Foreign Affairs Information Management Center, and am responsible for the maintenance of the records of the U.S. Department of State.

The attached document hereunto annexed is a true copy of a document retrieved from the files of the Department of State.

I declare, under penalty of perjury, that the foregoing statements are true and correct.

/s/ FRANK M. MACHAK

Frank M. Machak
Chief, Information Access and
Services Division

Attachment:

Official letter with note attached from the Italian Embassy to the Department of State, Washington, D.C., dated March 19, 1980.

AMBASCIATA D'ITALIA
WASHINGTON, D.C.

The Italian Embassy presents its compliments to the Department of State and, on behalf of the Nine EEC Governments, of which the Italian Government has now the presidency, it has the honor to forward the attached Note on the problems of the unitary method of taxation.

The Italian Embassy welcomes the opportunity to renew to the Department of State the assurances of its highest consideration.

Washington, D.C.
March 19, 1980

To the
Department of State
Washington, D.C

UNITARY TAXATION

1. Our Governments are concerned about the application to US subsidiaries of foreign companies of the unitary basis of taxation as applied in California and in varying degrees by certain other States.

2. The unitary basis makes no attempt to examine the profits generated by the subsidiary. It looks to the total profits of the worldwide operations of the group of which the subsidiary is a part, and claims a portion of those profits on the basis of the assumption that certain specified factors, such as the fixed asset values, turn-over and payroll, affect the profits of the subsidiary in the same way and to the same extent as the profits of the group as a whole, irrespective of where the corporations of the group operate. This means that, whenever the group as a whole makes a profit the subsidiary will be taxed on a portion of this profit, even if the subsidiary is actually making a loss, or in the reverse situation, that the subsidiary may not be taxed if the group as a whole has made a loss, although the subsidiary is actually in a profit making position.

3. This method is incompatible with the principles accepted by all OECD member states and recommended to all states as a basis for the taxation of subsidiaries or permanent establishments of foreign enterprises. These principles require that a subsidiary should be taxed only on the profits it actually has made, provided that these are based on dealing at "arm's length" between the subsidiary and related enterprises, i.e. that the transactions between the subsidiary and related corporations are on the same or on a comparable basis as transactions between wholly independent parties. This is intended to arrive at a fair measure of profit and rule out artificial pricing between members of the group for the sole purpose of minimizing tax liability.

4. Unless the same basic rules for calculating taxable profits are followed generally by the main trading nations it will be impossible to achieve the essential objective of providing a consistent and coherent international tax framework for trade and investment.

5. The unitary tax basis can give rise to obviously inequable tax liabilities, and to a form of double taxation which often cannot be relieved, or can be relieved only if countries, which follow generally accepted practices, bear an unfair burden of relief.

6. Unitary taxation, because it requires worldwide reporting of the group's activities in the state where the subsidiary operates imposes very heavy compliance costs, in addition to the costs of compliance and reporting for non-US corporations in their "home countries".

7. The Federal Government uses the arms-length basis for its taxation of subsidiaries of foreign corporations.

8. The problem was addressed in the US/UK Double Taxation Treaty, Article 9 (4) of the Treaty, which was supported by the Administration, would have disallowed the imposition of unitary taxes on subsidiaries of UK companies. When the Senate voted on the Treaty in 1978 the majority approved the Treaty with Article 9 (4) in its original form, although the necessary two-thirds majority was not achieved. Subsequently, the Senate approved the Treaty with the necessary two-thirds majority, but subject to the reservation that Article 9 (4) was not to apply for the purpose of state taxation. Article 9 (4) remained in the Treaty, but only for the purpose of national taxation.

9. There are currently four relevant bills in Congress. S983, S1688, HR 5093 and HR 5076, the last of which is scheduled for hearings on the 31st of March.

In the view of the strong arguments against unitary taxation, our Governments urge you to support this legislation in so far as it relates to the unitary tax issues raised above, with a view to early enactment.

Washington, D.C.
March 19, 1980

EXHIBIT 32C

United States Department of State
Washington, D.C. 20520

July 10, 1985

To Whom It May Concern:

I, Frank M. Machak, state the following:

I am Chief, Information Access and Services Division, Foreign Affairs Information Management Center, and am responsible for the maintenance of the records of the U.S. Department of State.

The attached document hereunto annexed is a true copy of a document retrieved from the files of the Department of State.

I declare, under penalty of perjury, that the foregoing statements are true and correct.

/s/ FRANK M. MACHAK

Frank M. Machak
Chief, Information Access and
Services Division

Attachment:

Note No. 51 from the British Embassy to the Department of State, Washington, D.C., dated March 25, 1980.

1. Her Britannic Majesty's Embassy present their compliments to the Department of State and have the honour to refer to the discussions between representatives of the two Governments about the convention between the Government of the United Kingdom of Great Britain and Northern Ireland and the Government of the United States of America for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income and capital gains, signed at London on 31 December 1975, as amended by protocols signed at London on 26 August 1976, 31 March 1977 and 15 March 1979 (hereinafter referred to as "the Convention"). It is a matter of regret to her Majesty's Government that difficulties over one aspect of the Convention, although it is an important one, should have tended to obscure the

achievement of the two Governments in reaching a fair and balanced agreement.

2. Among double taxation treaties, that between the British and United States Governments has a pre-eminent position. The economic and financial links between the two nations are so strong and the areas covered so diverse that, apart from its intrinsic importance to the United Kingdom and the United States of America, the Convention attracts wide interest internationally and is a source of authority in its field.

3. Her Majesty's Government is therefore gravely concerned that as a result of the amendment resulting from the United States Senate reservation on Article 9(4) the Convention does not comprehensively restrict the application of the unitary basis of taxation. That Article in its original form would have prevented the United States Government and the individual States of the United States of America from applying this basis to United Kingdom corporate groups which have subsidiary companies in the United States. In its final form the Article applies only for the purposes of United States federal tax, where the unitary basis is not employed, and does not cover individual States of the Union. This is not only a set-back for British corporate investment in the United States. It may also be interpreted as awarding some approval for the unitary basis of taxation and could have wider repercussions.

4. Her Majesty's Government is convinced that the unitary basis of taxation with combined reporting, particularly as applied in the international field, is entirely unsatisfactory. The Organisation for Economic Co-operation and Development has explored, encouraged and developed the "arms's-length" principle for regulating the taxation of multinational enterprises operating through subsidiary companies or branches. This principle requires that the subsidiary or branch should be taxed only by reference to the profits which its own activities generate. Where these activities involve transactions with related enterprises and these transactions are not on the basis which would be made between wholly independent enterprises, the profits are to be adjusted for tax purposes by reference to the independent enterprise test i.e., the "arms-length" basis. This is intended to achieve a fair measure of

the profit by cancelling the effect of any artificial pricing between related enterprises. The "arms-length" approach has been internationally accepted and is a vital feature of double taxation conventions throughout the world.

5. The unitary basis with combined reporting is a quite different approach. It makes no attempt to examine the profits made by the locally based subsidiary company. It may look to the total profit of the world-wide operations of the group and claim a proportion of that total by reference to arbitrarily defined criteria. The problems associated with this technique are many and have been well rehearsed. The tax consequences are unpredictable and arbitrary. The widely varying commercial and economic climates in different countries produce inequitable results. Under this system it can lead to a demand for tax by reference to group profits earned from unconnected activities to other parts of the world where they are already taxed, even although the local subsidiary is incurring substantial losses. On the unitary basis there is likely to be unrelieved and unrelievable double taxation. In addition the compliance costs are unacceptably high.

6. Apart from these inherent problems associated with the unitary tax basis, its incompatibility with the internationally accepted "arm's-length" basis would generate conflicts between the international investing and trading nations and disruption of international business if the precedent implicit in the Convention were to be followed by other countries. Unless common rules for determining the allocation of profits between different taxing jurisdictions are followed internationally it will be impossible to preserve the essential objective of providing a consistent and coherent international tax framework for business and investment, for which the United States and the United Kingdom have striven together with their fellow members of the Organisation for Economic Co-operation and Development. It is the view of Her Majesty's Government that the unitary basis, which is not a practical international alternative to the "arm's-length" basis, could undo the important and patient international work that has been achieved in regulating international tax practices, and that every effort is required to discourage the use of the extension of that basis. It is to this end that the British and United States

Governments have expressly prohibited its use for the purpose of the respective national tax systems under Article 9(4); and the issue will be an important aspect of the proposed annual review of the Convention.

7. Her Majesty's Government has recognised, in ratifying this Convention with the approval of the United Kingdom Parliament, and in its acceptance of the United States Senate reservation against Article 9(4) of the Convention, the difficult issues raised within the United States in seeking to limit State taxing powers through the double taxation conventions of the United States. It has also recognised the importance of the Convention in its many other aspects for the two Governments and for the business and investment communities on each side. It must be emphasized however that the acceptance of the Senate reservation in no way implies approval of the unitary basis and it is the urgent request of Her Majesty's Government for the reasons given in this Note that the Government of the United States should use its best endeavours to eliminate the international application of the unitary basis of taxation.

8. The British Embassy avail themselves of this opportunity to renew to the Department of State the assurances of their highest consideration.

British Embassy
WASHINGTON

25 March 1980

EXHIBIT 32G

United States Department of State
Washington, D.C. 20520

June 21, 1985

TO WHOM IT MAY CONCERN

I, Frank M. Machak, state the following:

1. I am Chief, Information Access and Services Division, Foreign Affairs Information Management Center and responsible for the maintenance of the records of the U.S. Department of State.

2. The attached document hereunto annexed is a true copy of a document retrieved from the files of the Department of State.

I declare, under penalty of perjury, that the foregoing statements are true and correct.

/s/ FRANK M. MACHAK

Frank M. Machak
Chief, Information Access and
Services Division

Attachment:

Note No. 283 from the Canadian Embassy to the Department of State, Washington, D.C., dated June 14, 1982.

CANADIAN EMBASSY
AMBASSADE DU CANADA

No. 283

The Embassy of Canada presents its compliments to the Department of State and has the honour to refer to its Notes No. 692 and 245 of 22 December, 1981 and 10 May, 1982, together with the exchange of letters between the Secretary of the Treasury for the United States of America and the Canadian Minister of Finance of 26 September, 1980 on the occasion of the signing of the bilateral convention with respect to taxes on income and capital.

The Embassy has been instructed to draw again the attention of United States authorities to Canada's concerns about the unitary tax apportionment method used by certain states in the United States to allocate income to United States offices or subsidiaries of international corporations based on the corporation's worldwide earnings. The Canadian Government continues to be of the view that this method results in inequitable taxation and imposes excessive administrative burdens on international companies doing business in those states. Under this method the profit of a Canadian company, for example, on its United States business is not determined on the basis of arm's-length relations, but is derived from a formula taking account of the income of the Canadian company and its worldwide subsidiaries, as well as the assets, payroll and sales of each of these.

For a multinational company with subsidiaries in different countries to have to submit its books and records for all of these companies to a state of the United States imposes a costly burden.

Against this background the Canadian government welcomed the decision of the Justice Department to file an amicus curae brief before the Supreme Court concerning the appeal of the Chicago Bridge and Iron Company against the use of the unitary tax method applied by the State of Illinois. The Embassy has now noted that another such case will be considered by the Supreme Court later this year involving an appeal by Container Corporation of America versus the Franchise Tax Board (California)

(Case 81-523). The Embassy would wish the foregoing concerns of the Canadian Government to be drawn to the attention of the relevant United States authorities and would welcome these views being referred to in any representation that the United States Administration may be making to the Supreme Court.

The Embassy of Canada avails itself of this opportunity to renew to the Department of State the assurances of its highest consideration.

Washington, June 14, 1982

EXHIBIT 32I

United States Department of State
Washington, D.C. 20520

June 21, 1985

TO WHOM IT MAY CONCERN

I, Frank M. Machak, state the following:

1. I am Chief, Information Access and Services Division, Foreign Affairs Information Management Center and responsible for the maintenance of the records of the U.S. Department of State.

2. The attached document hereunto annexed is a true copy of a document retrieved from the files of the Department of State.

I declare, under penalty of perjury, that the foregoing statements are true and correct.

/s/ FRANK M. MACHAK

Frank M. Machak
Chief, Information Access and
Services Division

Attachment:

Official letter with attached note from the Embassy of Greece to the Department of State, Washington, D.C., dated August 1, 1983.

EMBASSY OF GREECE
WASHINGTON, D.C.

The Embassy of Greece presents its compliments to the Department of State and, on behalf of the Ten European Community Governments, of which the Government of Greece has now the presidency, it has the honor to forward the attached Note on the problems of the unitary method of taxation.

The Embassy of Greece welcomes the opportunity to renew to the Department of State the assurances of its highest consideration.

Washington, D.C., August 1983

Attached: Note

The Department of State
Washington, D.C.

UNITARY TAXATION

I.

Our governments refer to their note on unitary taxation forwarded to the Department of State by the Embassy of Belgium on 29 June 1982.

II.

That note drew the attention of the State Department to the case before the Supreme Court of the Container Corporation of America versus the California Franchise Tax Board and urged as a matter of high priority that the government of the United States should participate in that case as amicus curiae. The decision was handed down by the court on 27 June, 1983, and the court found that application of the unitary business principle by the State of California to Container Corporation and its foreign subsidiaries was proper. A majority of justices held that that fact that no brief had been submitted on behalf of the United States government meant there was no indication that the position taken by the government in the case of the Chicago Bridge and Iron Company still represented its views or that the brief in the Chicago Bridge case applied to the Container case.

III.

Although the Supreme Court decision did not apply to US companies with foreign parents, our governments were disappointed by the Container decision. They remain convinced that the unitary basis of taxation with combined reporting, particularly as applied in the international field, is unsatisfactory. Our governments therefore urge that the United States government should give strong support to legislation to ensure that States do not use that method of taxation at least for the subsidiaries of foreign corporations. There are currently two relevant bills in Congress, HR 2918 and S.1225.

IV.

It is particularly important that federal legislation should be adopted at an early stage since there are already signs that, following the decision in the Container case, other American States not at present using this method are contemplating adopting worldwide combined reporting.

EXHIBIT 32L

United States Department of State
Washington, D.C. 20520

June 21, 1985

TO WHOM IT MAY CONCERN

I, Frank M. Machak, state the following:

1. I am Chief, Information Access and Services Division, Foreign Affairs Information Management Center and responsible for the maintenance of the records of the U.S. Department of State.

2. The attached document hereunto annexed is a true copy of a document retrieved from the files of the Department of State.

I declare, under penalty of perjury, that the foregoing statements are true and correct.

/s/ FRANK M. MACHAK

Frank M. Machak
Chief, Information Access and
Services Division

Attachment:

Note No. 461.20-LJ/hu from the Embassy of Switzerland to the Department of State, Washington, D.C., dated November 15, 1983.

EMBASSY OF SWITZERLAND

461.20 - LJ/hu

The Embassy of Switzerland presents its compliments to the Department of State and has the honor to draw its attention to the following.

At its first meeting on November 2, 1983 the Working Group on Worldwide Unitary Taxation set up a Task Force which will hold hearings on November 16 and 17, 1983. The Embassy of Switzerland has kindly been invited to make its views known to the Task Force.

In a note dated March 16, 1983 the Swiss Embassy has already drawn the Department of State's attention to the serious concerns of the Swiss Government with regard to the unitary method of taxation. It welcomes the opportunity to explain once again the reasons of its position and kindly asks the Department of State to convey the content of this note to the Task Force.

The method of unitary taxation used by certain states of the United States allocates income of Swiss-owned companies with no United States contacts to subsidiaries of such Swiss-owned companies operating in the United States.

The Department of State
Washington, D.C.

This method thereby can produce inequitable results often including double or arbitrary taxation, and imposes expensive administrative and compliance burdens.

The unitary method of taxation lumps together all the worldwide income of a related group of corporations, whether that income was derived from the taxing state or not, so long as the group is engaged in a "unitary" business. The concept of what constitutes a unitary business is often liberally construed by the taxing jurisdiction, and in some instances is interpreted so broadly that it imposes no restrictions on the state's power to tax related corporations.

Furthermore, a formula based on sales, payroll, and assets is applied to that worldwide income to determine the income attributable to the taxing jurisdiction. However, the formula necessarily produces skewed results in the international setting because it assumes that the factors in the formula affect the profits of the subsidiary with U.S. operations in the same way and to the same extent as they do the profits of the related foreign companies. In fact, though, wages, real property costs, and depreciation allowances vary so widely from country to country that sales, payroll and assets often fail to bear the same relation to income in one country as in others.

Finally, the taxing state's income tax rate is applied to the "income" base computed by the steps described above. As a result a taxpayer may actually be liable for taxes for a year in which it has had losses in the taxing jurisdiction.

There can be no doubt that the unitary tax method is incompatible with the internationally accepted arm's length principle. Indeed, it has been argued in a number of recent U.S. Supreme Court cases that it is violative of international law. Under internationally accepted principles, each company is treated as a separate entity. A nation or a political subdivision of a nation (for example, a state of the United States or a Swiss canton) may tax all the income of any resident company, but may only tax nonresident companies on income arising within its jurisdiction. The taxing jurisdiction then uses the "arm's-length" method to ensure that no improper income-shifting occurs. Tax authorities may

recharacterize transactions between or among related companies so as to achieve an "arm's-length" result, thereby recapturing for the income base within the jurisdiction improperly shifted profits. This system has operated effectively to arrive at fair profit allocations and to prevent artificial income-shifting intended to reduce tax liability.

Furthermore, taxation under the unitary method imposes severe compliance costs on foreign parent companies. Such parent companies must submit their books and records for all of their worldwide related companies to each state of the United States that employs the method. They must consolidate their worldwide accounts according to the specific and different requirements of each such state, and convert numerous foreign currencies into U.S. Dollars. Swiss parent companies must convert the results of worldwide operations into Swiss Francs and then reconvert them into U.S. Dollars for unitary tax purposes. In the case of such foreign parent companies in non-English-speaking countries, there are significant translation costs. These compliance burdens are especially serious for many Swiss-based multinational enterprises because of their extensive worldwide operations.

Monetary exchange problems distort true economic income. As noted, for purposes of reporting in each unitary tax state, a Swiss parent company must convert the income of each related company from the currencies of the various countries in which those profits were earned into Dollars at the time each state requires a unitary tax report, even though the expression in Dollars of the results of operations may bear little relationship to economic reality. Fluctuations in the value of the Dollar may increase (or decrease) unitary income in a manner which does not reflect real economic income. These problems are much greater for foreign-based multinationals than for companies based in the United States since the latter maintain their consolidated financial reports in U.S. Dollars.

The application of the unitary tax method to foreign parent companies by certain states of the United States stands as a significant nontariff barrier to trade. Like most such barriers, the unitary method adversely affects the nation in which it is imposed as well as the target nations. The method can chill international

investment and decrease efficient allocation of resources and employment opportunities.

In particular, the unitary method can impede foreign entry into the United States market. During the start-up period of investment in a foreign nation or in a new state, costs tend to be high and profits low, yet, under the unitary method, a tax may be imposed because of the operations of related companies outside the state, even though the newly-created company is clearly operating at a tax and economic loss.

Still another danger of the unitary method to both the United States and its trading partners is the possibility of its spreading by example to nations that do not now use it, especially developing countries. The burden on international trade could become unbearable, as multiple taxation of corporate income and compliance burdens increase out of control. The Council of the Organisation for Economic Co-operation and Development (OECD) highlighted that threat in its recent report on transfer pricing, which denounced the unitary method.

The Embassy of Switzerland avails itself of this opportunity to renew to the Department of State the assurances of its highest consideration.

Washington, D.C.
November 15, 1983

EXHIBIT 32M

United States Department of State
Washington, D.C. 20520

June 21, 1985

TO WHOM IT MAY CONCERN

I, Frank M. Machak, state the following:

1. I am Chief, Information Access and Services Division, Foreign Affairs Information Management Center and responsible for the maintenance of the records of the U.S. Department of State.

2. The attached document hereunto annexed is a true copy of a document retrieved from the files of the Department of State.

I declare, under penalty of perjury, that the foregoing statements are true and correct.

/s/ FRANK M. MACHAK
Frank M. Machak
Chief, Information Access and
Services Division

Attachment:

Official letter forwarding attached note from the Embassy of the Federal Republic of Germany to the Department of State, Washington, D.C., dated November 28, 1983.

The Embassy of the Federal Republic of Germany presents its compliments to the Department of State and, on behalf of the Government of the Federal Republic of Germany, has the honor to forward the attached note on the problems of the unitary method of taxation. This note is delivered simultaneously to the Department of the Treasury for attention of the Presidential Working Group on worldwide unitary taxation.

The Government of the Federal Republic of Germany is deeply concerned about the application of the unitary basis of taxation by several states to US subsidiaries of foreign companies. This method is incompatible with worldwide agreed principles on international taxation. Applying the unitary method approach, the federal states have discontinued to adhere to an internationally accepted consensus based on the arm's-length principle of taxation.

A satisfactory solution to the problem is crucial to any improvement in the tax relationship between the Federal Republic of Germany and the United States of America and specifically for an eventual revision of the Agreement for the Avoidance of Double Taxation with respect to Taxes on Income.

In view of the strong arguments against unitary taxation the Federal Government therefore urges the United States Government to give strong support to pending legislation aiming at abandoning the unitary method of taxation at least for the subsidiaries of foreign companies.

The Embassy of the Federal Republic of Germany welcomes the opportunity to renew to the Department of State the assurances of its highest consideration.

Washington, D.C.
November 28, 1983

Embassy of the
Federal Republic of Germany

November 28, 1983

Washington, D.C.

MEMORANDUM TO THE UNITED STATES DEPARTMENT OF THE TREASURY

on the issue of State taxation by worldwide combination and formula apportionment ("unitary taxation")

The Government of the Federal Republic of Germany is deeply concerned about an increasing international incidence of State taxation in the United States of America with respect to German-based multijurisdictional enterprises. It is the intention of the following memorandum to bring the position of the Federal Government to the attention of the Department of the Treasury so it may take into consideration when reviewing the unitary tax issue within the Working Group appointed by the President of the United States.

1. *Unrelieved double taxation*

When a worldwide combination of business income along with formula apportionment is used to calculate a share in unitary group income as a State's tax base, this will invariably attract income or loss elements which were not generated by the State-based entity itself to the State availing itself of such a taxation method. Whether the application of this method results in an advantage or disadvantage for the State, and the multijurisdictional enterprise respectively, depends on the individual case. The best evidence for unitary taxation working either way is the case history available of enterprises litigating both against and in favor of its application before United States courts. Empirical data on the aggregate results of unitary taxation and on the differences in tax costs vis-à-vis arm's length results is just as difficult to collect as it is burdensome to comply with unitary tax rules. These uncertainties inherent to the unitary approach are compounded by the concern that the uncoordinated, simultaneous application of unitary and arm's length concepts internationally will lead to tax

claims of the fiscs involved which, in aggregate, do not reflect economic reality. In contrast to a water's edge approach of combination and apportionment, which would appear to constitute a fair compromise between the need for State revenue and administrative simplicity, unitary approaches, when applied in an economically inhomogeneous international environment, result in a serious misallocation of income. If a United States entity of a German group bears increased costs or experiences a temporarily unprofitable situation, e.g. in start-up or expansionary phases or under other special circumstances of competition, an overassessment in the unitary State (and international double taxation) will be the result because a fair corollary for the partial taxation of foreign income of other — more profitable — group members in the form of a foreign tax credit is not granted.

2. *Compliance cost*

While the evaluation of the actual overall revenue implications of unitary taxation involves considerable judgment at this stage and warrants further exploration, the compliance cost and the administrative burdens engendered by unitary tax statutes are manifest. Not only will a German multijurisdictional enterprise have to consolidate the accounts of the unitary business entities worldwide — a task which is presently otherwise not required for tax purposes under German or United States federal laws and which is particularly painstaking as the delineation of a unitary business neither follows uniform rules under the various State statutes nor always coincides with corporate structures under commercial law. The enterprise will furthermore have to recalculate the combined reports on a dollar basis and adjust its balance sheet items to accommodate differential State accounting and valuation provisions. These administrative burdens are compounded by the high cost of having foreign accounts certified and the cost of special computations required to determine the various factors used in the apportionment calculation. On the other hand, the verification and examination of the various books and records necessary to ensure full compliance with unitary statutes is well in excess of what would appear to be feasible for a State administration whose aim it is to use its resources in a more productive way than under an arm's length concept. The Government of the

Federal Republic of Germany therefore is convinced that, due to these constraints, the administration of unitary tax schemes has to settle for a low degree of precision. It may often have to take recourse to rough estimates and this may even become the normal procedure in the majority of cases. Furthermore, the multijurisdictional enterprise, with respect to compliance cost, is at a disadvantage when compared with a United States based multijurisdictional group which has no part of its unitary business abroad or whose compliance on a dollar basis will be less burdensome.

3. *Direct investment hampered*

The Federal Government emphasizes the fact that German enterprises which have to face the likelihood of double taxation and the compliance cost caused by unitary taxation will have to take their business and investment decisions with a view to the rather mixed tax environment created in the United States by the various forms of State taxation. Tax-induced misallocation of resources both within the United States and internationally is unavoidable if no satisfactory solutions to these impediments can be found. Capital and trade flows between our two countries will be distorted and, to a certain extent, possibly disrupted if the competitive disadvantage of "being multinational" as opposed to "just domestic" is exacerbated instead of reduced by the introduction of unitary statutes by more State legislatures, and a failure to eliminate their negative international impact in those States where they already exist.

4. *Setback for international consensus*

In the past, the free flow of investment capital and trade between the United States and the Federal Republic of Germany has been imbedded in a bilateral tax environment which cannot be viewed in isolation of international developments. The international community has endeavored for decades to create an international tax system that avoids barriers and distortions and gives adequate protection to international trade and investment. In multilateral discussions first initiated by the League of Nations a consensus has emerged — among developing as well as industrialized countries — in favor of the arm's length principle of taxation.

The Federal Republic of Germany and the United States have contributed actively to these endeavors. The unitary approach to taxation of foreign-based enterprises runs counter to this consensus and may be the beginning of its disruption. A failure to bring this development to a halt and to eliminate the international incidence of unitary taxation might lead the international community to conclude that the United States has ceased to speak with one voice and thus is no longer contributing to the international tax order toward which the United States, the Federal Republic of Germany and other nations have worked for so many years. Other countries may follow the practice of unitary States taxation — and there are signs that some of them have already taken steps to safeguard such moves bilaterally — if the conflict with the developed international consensus is not resolved soon. Such a danger of disruption of the international consensus through inaction is a matter of great concern to the Federal Government, irrespective of whether the negative impact falls immediately on German-based investors in the United States or on United States investors in Germany.

5. *Treaty implications*

In a bilateral context, a unitary approach which stops at water's edge and which limits the aggregate of apportioned tax bases to the total domestic tax base cannot be reason for concern. It constitutes a mere proxy for revenue sharing between various national and sub-national jurisdictions. This understanding is reflected in the U.S. — German Tax Treaty to the extent that it grants protection for German Trade Tax, a tax based on a unitary approach limited to domestic income apportionment. The foundation for the present understanding, however, is upset where unitary schemes are implemented across national frontiers. The German enterprises, faced with the incidence of such practices, have every right to be concerned and to solicit protection against such imbalances. In the absense of internal legislation by the United States Congress, the only means to provide protection would appear to be the Tax Treaty itself. The Federal Government therefore feels that the problem of establishing a balanced treaty framework which appropriately addresses the unitary issue needs to be considered. The Federal Government cannot totally

exclude that the different treatment of the German Trade Tax and unitary State taxes under the present treaty will prove to be counterproductive to a speedy conclusion of the ongoing Treaty renegotiations if the international implications of unitary State taxes continue to exist in the future.

EXHIBIT 32P

United States Department of State
Washington, D.C. 20520

June 21, 1985

TO WHOM IT MAY CONCERN

I, Frank M. Machak, state the following:

1. I am Chief, Information Access and Services Division, Foreign Affairs Information Management Center and responsible for the maintenance of the records of the U.S. Department of State.

2. The attached document hereunto annexed is a true copy of a document retrieved from the files of the Department of State.

I declare, under penalty of perjury, that the foregoing statements are true and correct.

/s/ FRANK M. MACHAK
Frank M. Machak
Chief, Information Access and
Services Division

Attachment:

Note from the Embassy of Belgium to the Department of State, dated January 25, 1984, attaching Memorandum of the Government of Belgium on Worldwide Unitary Taxation.

The Embassy of Belgium presents its compliments to the Department of State and, on behalf of the Belgian government, has the honor to forward the attached memorandum on the problems of the worldwide unitary taxation. This memorandum is also being sent to the Department of the Treasury to the attention of the presidential working group on worldwide unitary taxation.

The system of unitary taxation leads to double taxation and also imposes heavy and costly administrative burdens on the corporations involved. The extension of this system to additional States would aggravate the harm already done to the harmonious development of international economic relations. The Belgian government therefore holds the view that it is essential that measures be taken to bring the States to repeal the system of unitary taxation.

The Embassy of Belgium welcomes the opportunity to renew to the Department of State the assurances of its highest consideration.

Washington D.C.
January 25, 1984

Attached: Memorandum.

The Department of State
Washington D.C.

MEMORANDUM OF THE GOVERNMENT OF BELGIUM ON WORLDWIDE UNITARY TAXATION.

The system of unitary taxation, which is at present used by a growing number of States in the United States with respect to taxation of corporate income, has been opposed for many years not only by corporations subject to this taxation system but also by foreign countries, inter alia by European countries.

On several occasions the Member States of the European Community — including Belgium — have conveyed to the Department of State the concern of their business community regarding the system of unitary taxation. They expressed the wish that the U.S. government should take measures aimed at repealing this taxation system.

The Belgian government wishes to bring once again to the attention of the working group, established to examine the effects of unitary taxation, its firm attachment to the universally accepted rules governing the taxation of corporations operating in several countries, and which are included in the OECD Model Taxation Convention of 1977. It expresses therefore its resolute opposition to the system of unitary taxation presently used by a large number of States in the United States.

The Belgian government bases its opposition to this system mainly on the following grounds:

— In the present international context unitary taxation leads to double taxation of corporate income, through the conflict the unitary system generates with conventional methods of income determination, used by all other countries including the United States at the federal level;

— Unlike the principle of independent enterprise, the principle of unitary taxation does not necessarily imply the use of uniform implementation rules. It thus cannot be considered as a principle allowing systematic avoidance of double taxation, quite to the contrary;

— The unitary approach imposes heavy and costly administrative burdens on the corporations involved;

— The extension of this system to additional States would aggravate the harm already done to the harmonious development of international economic relations.

1. *DOUBLE TAXATION.*

The various international organizations, which, for more than half a century, have tackled the problems caused by international double taxation, have always been striving for the greatest possible uniformity in the principles used to define the conditions and the scope of taxability. With respect to the taxation of subsidiaries and branches of foreign corporations, the fundamental principle chosen and since then universally applied is that only the income *effectively* earned by these subsidiaries and branches can be taxable and this of course to the extent that the transactions with other entities of the group took place under conditions of free competition ("arm's length").

This fundamental principle implies, on the one hand, that only income which is the direct result of the activities of the subsidiaries and branches themselves can be taxable; it implies, on the other hand, that the amount of taxable income must normally be determined on the basis of real data, as they appear in the accountancy, if necessary corrected, of the aforementioned subsidiaries and branches.

The choice of this method for establishing taxable income has been guided by the will to confer to the taxation of subsidiaries and branches a strictly territorial scope i.e. not extending beyond the borders of the countries involved. The above mentioned system of determination of taxable income is nowadays admitted in all countries. Furthermore, the experience gained led to rules allowing the implementation of this system in a way effectively avoiding problems of double taxation.

In such a context, use of the system of unitary taxation creates a situation in which double taxation becomes unavoidable, since this system usually leads to a higher level of taxable income than would be obtained by applying the principle of independent enterprise.

One must point out in this connection that the use of the unitary approach essentially aims at increasing the fiscal revenues of the States.

2. *NO UNIFORM IMPLEMENTATION RULES.*

The Belgian government remarks that the principle underlying the method of unitary taxation — i.e. each entity of the group participates in the prosperity of the whole — does not imply, unlike the principle of independent enterprise, that all the States which apply this method have to use rules of determination of taxable income that are at the same time *accurate* and *uniform*.

One notices, in this respect, that the States in the U.S. select criteria of apportionment which are favorable to them. These criteria however do not bind other States. Indeed, these other States can choose other criteria capable of providing them also with increased revenues.

In the same way, the amount of *worldwide* profit of the corporation is determined by specific rules of each State. This amount can therefore vary from State to State.

Double taxation can clearly not be avoided in a situation where variable criteria are applied to a variable amount of profits.

3. *ADMINISTRATIVE BURDEN.*

In order to permit determination of the worldwide profit to be divided between the various subsidiaries and branches involved, these subsidiaries and branches have to communicate the accounting statements of each entity (foreign or not), member of the group. These statements must conform to the accounting standards used in the State where the subsidiary or the branch is located. Furthermore, these statements must be presented in U.S. dollars.

These requirements imply a marked and costly increase of administrative burden for the groups involved. This stems above all from the disparity of the accounting standards used by the different entities of aforementioned groups and also from the fact that the accounting periods of the same entities might not

correspond with the fiscal year of the State where the subsidiary or the branch is located.

The administrative burdens of the foreign groups are necessarily heavier and costlier than those of groups operating only in the United States. Moreover, as a matter of principle, it is questionable to request from a legally autonomous subsidiary the accounts of a foreign corporation.

4. *Damage to International economic Relations.*

It is useful to point out that other American States or other countries could follow suit and adopt the unitary approach, either to misappropriate higher revenues or — this in the case of other countries — as a retaliatory measure.

The extension of the use of this taxation system would further increase the damage to international economic relations. It would hurt in particular countries which as Belgium take an active part in the development of international trade.

The Belgian government's viewpoint is that it is essential that measures be taken to bring the States to repeal the system of unitary taxation. At the very least, using this system should be strictly limited to exceptional cases and subject to the condition that the results thus produced would not diverge appreciably from those obtained through the use of the principle of independent enterprise.

Finally, in order to facilitate for the States in the U.S. the implementation of the universally recognized principle, that only the income effectively earned by subsidiaries and branches can be taxable (with due regard for the arm's length rule), the Belgian government would be prepared to add in the double taxation Convention being negotiated between Belgium and the United States, provisions allowing for the communication to these States of information which will be exchanged under the terms defined by said Convention.

Washington D.C., January 25, 1984.

EXHIBIT 32W

Washington, D.C. March 18, 1985

EMBASSY OF SWEDEN
THE AMBASSADOR

The Honorable
George A. Sinner
Governor of North Dakota
State Capitol
Bismarck, North Dakota 58505

Dear Governor Sinner:

Attached is an informal note on the issue of unitary taxation that is now under consideration in the North Dakota legislature. The text of the note has been agreed upon by the Governments listed, and by the Commission of the European Communities.

I have sent copies of this message to Secretary Baker, the Department of the Treasury, Under Secretary of State Allen Wallis, the Department of State, Mr. Kent Conrad (State Tax Commissioner), Senator David E. Nething (Sponsor) and Representative Alvin Hansauer (Chairman of the House Finance and Taxation Committee).

Sincerely,

W. Wachtmeister

UNITARY TAXATION IN NORTH DAKOTA

The Governments listed below and the EC Commission are opposed to the application of the unitary method of taxation on a worldwide reporting basis because they do not regard it as a viable alternative to the separate accounting method.

Worldwide unitary taxation is not compatible with well established international principles of taxation, and imposes unreasonable tax and administrative burdens on multinational corporate groups doing business throughout the world. It is damaging to commercial and economic relations between the US and our countries. If it continues, the damage to international trading relations will become more serious and investment in North Dakota will become less attractive than in other States that do not apply this form of taxation.

Our Governments welcome the serious consideration being given in North Dakota to proposals for confining unitary taxation to the "water's edge". But they believe that it is very important that the "water's edge" should be clearly defined so as to provide an internationally acceptable basis for determining the profits of overseas companies and overseas groups properly allocable to North Dakota. In particular they believe that all proposals for 'thresholds' should be removed for foreign companies and their activities within the United States taxed as if they were the activities of an independent company: the 90 per cent criterion for qualification as a tax haven should be substantially lowered: all companies, whatever the nature of their business, should be eligible for "water's edge" treatment: and this should not be subject to withdrawal by the State without the taxpayer's agreement. Also the compliance burden should be minimised. We trust that before the legislation is enacted SB 2343 will be amended to make it consistent with the above objectives.

/Australia

Australia
Austria
Belgium
Canada

Denmark
Finland
France
The Federal Republic of Germany
Greece
Ireland
Italy
Japan
Luxembourg
The Netherlands
Norway
Sweden
Switzerland
The United Kingdom
The Commission of the European Communities

EXHIBIT 32CC

TEXT OF LETTER FROM THE UNITED KINGDOM CHANCELLOR OF THE EXCHEQUER TO THE SECRETARY OF THE UNITED STATES TREASURY DATED 20 JUNE 1985

UNITARY TAXATION

I AM SORRY NOT TO HAVE BEEN ABLE TO SEE OR SPEAK TO YOU MYSELF, BUT I HAVE ASKED GEOFFREY LITTLER TO GIVE YOU THIS LETTER AND EXPLAIN WHY WE ARE COMPELLED TO TAKE ACTION HERE OVER UNITARY TAX.

WHEN WE TALKED OVER THE SUBJECT IN WASHINGTON ON 19 APRIL I TOLD YOU OF THE PRESSURE IN OUR PARLIAMENT FOR RETALIATION AND THE PROBABILITY THAT IT WOULD BECOME VERY STRONG IN THE EARLY SUMMER IF SUFFICIENT PROGRESS HAD NOT BY THEN BEEN MADE TOWARDS REFORM IN THE U S, ESPECIALLY IN CALIFORNIA. I EXPLAINED THEN THAT OUR PARLIAMENTARY TIMETABLE HERE COULD WELL REQUIRE ME TO MAKE AN EARLY DECISION ON WHETHER TO ALLOW RETALIATORY LEGISLATION TO PROCEED. OUR 1985 FINANCE BILL, WHICH COVERS TAX LEGISLATION, IS NOW WELL ADVANCED, AND I COULD NOT HOLD UP CONSIDERATION OF UNITARY TAX ANY LONGER.

I HAVE DECIDED THAT, IN VIEW OF THE DISAPPOINTING PROGRESS TOWARDS A SOLUTION — PARTICULARLY IN CALIFORNIA — THE GOVERNMENT CAN NO LONGER STAND IN THE WAY OF LEGISLATION IN THE HOUSE OF COMMONS. THIS WOULD, IF PASSED, PROVIDE US WITH DISCRETIONARY RESERVE POWERS THAT COULD BE IMPLEMENTED IF THE PROBLEM REMAINS UNRESOLVED.

IT GOES WITHOUT SAYING THAT I HOPE THAT THESE POWERS NEED NEVER BE INVOKED. I TRUST CONTINUED PRESSURE FROM THE FEDERAL ADMINISTRATION WILL ENCOURAGE CALIFORNIA AND OTHER STATES TO FIND SOON AN ACCEPTABLE SOLUTION OR — FAILING THIS — THAT THE ADMINISTRATION WILL SECURE THIS BY FEDERAL ACTION.

I THOUGHT YOU SHOULD KNOW OF THIS BEFORE WE MAKE A PUBLIC ANNOUNCEMENT TOMORROW.

EXHIBIT 32DD

MEMORANDUM

From: The Netherlands Government
To: The Governor of California

The Netherlands Government has serious objections to the phenomenon of world-wide unitary taxation. It has expressed these objections on numerous occasions. These objections may be summarized as follows:

— unitary taxation greatly enhances the risk of international double taxation;

— unitary taxation produces unfair and inequitable results;

— unitary taxation imposes disproportionately heavy administrative burdens on non-U.S. based enterprises.

The Netherlands Government has noted with satisfaction that throughout the United States there is a strong tendency towards complete abolition of world-wide unitary taxation, or at least a move to adopt the water's edge principle. It has noted also with great interest that the California Legislature is considering limiting unitary taxation to the water's edge.

With regard to the position of the Netherlands Government on this important issue attention should be given to the following facts: The countries of Western Europe together provide for three quarters of total direct investment in the United States, totalling at the end of 1983 more than $90 billion. Official United States statistics show that direct investment in the United States from the Netherlands by the end of 1983 was approximately $29 billion. The Netherlands is thus the second largest single direct investor with investments nearly equalling that of the number one foreign direct investor, namely the United Kingdom with $32.5 billion. The increase in direct investment from Western Europe in 1983 amounted to $10 billion, nearly equal to Japan's total direct investment in the United States of $11 billion. The Netherlands imports the United States amount to approximately $5 billion, while exports to the United States are close to $3 billion. Despite the dollar exchange rate which heavily favors

exports from the Netherlands, there is still a trade deficit of $2 billion.

Trade between the Netherlands and California heavily favors California. The state exports two to three times more to the Netherlands than it imports.

Finally, the Netherlands firmly believes that international economic growth and well-being is dependent upon free trade and freedom of investment. The Netherlands has always defended these freedoms. The Government of the Netherlands, therefore, strongly urges the State of California to end world-wide unitary taxation.

EXHIBIT 32EE

PRIME MINISTER • PREMIER MINISTRE

OTTAWA, KLA OA2
September 24, 1983

Dear Ron,

I am writing to you to express the Canadian government's serious concern about the unitary tax issue which I understand you are now considering.

This method of taxation which permits individual state governments to levy taxes against the world-wide earnings of multinational corporations is, in our view, undesirable. In many cases, it places international enterprises in the position of having to pay tax in one jurisdiction for profits earned (and taxed) elsewhere.

The recent Supreme Court decision in the case of *Container Corporation vs the California State Franchise Tax Board* has considerably heightened the Canadian government's concerns. In addition to the serious potential for double taxation and the increased administrative costs for business, there is the danger that other states and countries, more occupied with a need for increased tax revenues than with consistent tax standards, may adopt this method.

The Honourable Ronald Reagan
President of the United States of America
The White House
Washington, D.C.

EXHIBIT 32GG

APPENDIX

Embassy of Japan
Washington

August 11, 1983

AIDE-MEMOIRE

Re: The Unitary Tax System

The Government of Japan wishes to present to the U.S. Government agencies concerned the following views with regard to the Unitary Tax System.

The Unitary Tax System, which has been introduced in California and many other states of the U.S., has put a serious burden and constraint on the management and business activities of Japanese-affiliated companies operating in the U.S. We regard the Unitary Tax System as having the following problems:

— It has been causing international double taxation.

— It requires financial and other documents from the companies concerned, which include not only those of the parent company, but of other affiliated companies all over the world, and thus has imposed a tremendous burden on them.

— It has a discouraging effect on Japanese investment in the U.S., and hampers the sincere efforts by the U.S. and Japanese Governments to actively promote Japan-U.S. investment.

Based on this recognition, the Japanese Government has taken every opportunity to raise this question in such fora as the Japan-U.S. sub-cabinet level meeting and Japan-U.S. Trade Subcommittee, and requested the U.S. Government to take appropriate measures as soon as possible to abolish the Unitary Tax System.

On June 27th, the U.S. Supreme Court decided in the Container Corp. of America *vs* Franchise Tax Board Case, that

the Unitary Tax System based upon the world-wide profits of the company concerned, including those of the overseas affiliated companies, is constitutional. Although the Court decision was not on a case in which the head office is located abroad, we are concerned that the decision would encourage a number of states to newly introduce the Unitary Tax System or discourage the states which already have the System from abolishing it. We wish to reiterate that Unitary Taxation can be a barrier to the expansion and development of Japan-U.S. economic relations, including the promotion of our direct investment.

The Government of Japan, attaching great importance to the U.S. Supreme Court decision of June 27th, again expressed concern over this matter in the Japan-U.S. Trade Subcommittee meeting held this July at Wye Plantation, Maryland. We were encouraged to hear the U.S. government explain that it is ready to present an amicus curiae brief in cases where diplomatic implication is involved. The Government of Japan strongly wishes that the U.S. Government will support the motion for rehearing, present the amicus curiae brief in connection with the rehearing of this case, and also take the same appropriate measures in connection with other individual cases. The Government of Japan further requests that the U.S. Government take concrete measures as soon as possible, including possible legislative actions, which will lead to the abolition of the Unitary Tax System.

EXHIBIT 32JJ

AMBASSADE DU GRAND-DUCHE
DE LUXEMBOURG
2200 MASSACHUSETTS AVENUE, N.W.
WASHINGTON, D.C. 20008
(202) 265-4171

30 August 1985

Dear Secretary Shultz,

Referring to our note verbale of August 8, we have the honor to convey to you the enclosed note verbale on unitary taxation on behalf of the Governments of the Member States of the European Communities and the Commission of the European Communities.

This note is submitted in response to the Treasury Department's request for comments on the draft legislation concerning unitary taxation that it had proposed on July 8.

We avail ourselves of the opportunity to renew to you the assurances of our highest consideration.

Sincerely,

PAUL PETERS
Paul Peters
Ambassador of Luxembourg

ROY DENMAN
Roy Denman
Head of Delegation
Commission of the European Communities

The Honorable
George P. Shultz
Secretary
U.S. Department of State
Washington, D.C. 20520

AMBASSADE DU GRAND-DUCHE
DE LUXEMBOURG
2200 MASSACHUSETTS AVENUE, N.W.
WASHINGTON, D.C. 20008
(202) 265-4171

30 August 1985

Dear Secretary Baker,

We have the honor to convey to you a note verbale on unitary taxation on behalf of the Governments of the Member States of the European Communities and the Commission of the European Communities.

This note is submitted in response to your request for comments on the draft legislation concerning unitary taxation that was proposed on July 8.

Sincerely,

PAUL PETERS
Paul Peters
Ambassador of Luxembourg

ROY DENMAN
Roy Denman
Head of Delegation
Commission of the European Communities

The Honorable
James A. Baker III
U.S. Department of the Treasury
Washington, D.C. 20220

1. The Governments of the Member States of the European Communities and the Commission of the European Communities wish to take advantage of the opportunity offered by the U.S. Government to comment on the proposed Federal Unitary Taxation Spreadsheet Legislation published by the Department of the Treasury on 8 July 1985.

They welcome the publication of the aforementioned proposed legislation as a contribution to a satisfactory solution of the problem of worldwide unitary taxation. They would like, however, to point out that some aspects of the proposed legislation cause concern to them.

2. The main areas of concern to the Governments of the Member States of the European Communities and the Commission arise from the definitions of "qualified state" and of "worldwide unitary basis". Under the proposed legislation, notwithstanding the fact that it applied a worldwide combination, a state would qualify in three cases:

(a) failure to comply with legal and procedural requirements;

(b) failure of the taxpayer or a foreign government to provide information after proper request;

(c) failure of separate accounting to prevent evasion of taxes.

On (a) the Governments and the Commission subscribing to this note object to the application of the system of worldwide unitary taxation. They equally object to the imposition of this method of taxation as a sanction to achieve certain legal or procedural requirements. Worldwide unitary taxation leads to a distortion in the international attribution of income for taxation purposes. The imposition of fines would seem to them the appropriate way of dealing with non-compliance.

On (b) the proposed legislation mentions failure of a foreign Government to provide information sufficient to determine the arm's length nature of transactions within a reasonable period of time as a ground for returning to worldwide unitary taxation.

Even when double taxation agreements have been revised, the Governments and the Commission are concerned that the draft

legislation does not provide adequate safeguards against information provided under treaties, and passed on to the States, being used other than for the purpose of applying unitary taxation to the relevant corporation.

The Governments and the Commission assume that, pending revision of treaties which, in their present form, do not allow the passing on to qualifying states of information provided by a foreign tax administration to the Internal Revenue Service, this provision does not subject their companies to worldwide unitary taxation. Further, these Governments and the Commission assume that inability on their part to provide information sought by states does not entail the imposition of worldwide unitary taxation.

On (c) the proposed legislation mentions failure to prevent evasion of taxes or clearly reflect income, even after appropriate adjustment, as a ground for imposing worldwide unitary taxation. The Governments and the Commission joined in these representations are unclear when such a case would occur. Separate accounting, where necessary adjusted for deviations from arm's length conditions, is the internationally agreed yardstick to measure the international distribution of income for taxation purposes. They, therefore, fear this case will cause much uncertainty for their taxpayers.

With respect to the definition of the worldwide unitary basis the Governments and the Commission note that the proposals almost entirely reproduce the concept of the water's edge combined group as defined by the Working Group under the chairmanship of Secretary Regan, as he then was. As they have pointed out earlier, this definition still causes them concern on a number of points. The Governments and the Commission refer in this respect to the letter of 16 January 1985 from the Chairman of the OECD Committee on Fiscal Affairs to Secretary Regan. In particular they are concerned about the thresholds for foreign companies to be included in the water's edge combination and about the definition of tax havens; the treatment of banks and certain other financial institutions is also unsatisfactory.

They would urge the Department of the Treasury:

(a) to substitute for the thresholds mentioned in the proposal the internationally accepted criterion of permanent establishment, and to tax foreign companies having a permanent establishment within the United States on a separate entity basis. This is the approach recommended to the States by former Secretary Regan in his letter to President Reagan on August 31, 1984.

(b) to bring the definition of tax havens into the proposed legislation and to align it with the guidelines accepted by the OECD countries (*).

(c) to insure that banks and other financial institutions are treated for tax purposes as subsidiaries, hence removing the present discrimination against such institutions arising from the fact that they generally operate on a branch or agency basis.

3. The Governments and the Commission welcome the proposed legislation as a contribution towards finding an internationally acceptable solution for the problems of worldwide unitary taxation. The proposed legislation in its present form, however, would offer federal assistance to States that have adopted or intend to adopt legislation which does not meet the concerns of these Governments and the Commission. Thus this legislation falls short of providing a stimulus to the States to adopt legislation that would actually solve this long-standing problem in a satisfactory way.

4. Our Governments and the Commission wish to express the hope that the Federal Government will continue to exert all its influence to convince the States of the necessity of finding an internationally acceptable solution to the unitary tax issue, or failing that, will propose further legislation of its own to achieve the same objective.

Washington, D.C.
August 30, 1985

(*) A tax haven is broadly defined as any country or territory which promotes improper shifting or sourcing of income or expenditure by virtue of its tax structure and/or tight banking or commercial secrecy provisions.

EXHIBIT 32LL

European Communities

EUROPEAN PARLIAMENT

Working Documents

1983-1984

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27 October 1983 DOCUMENT 1-967/83

MOTION FOR A RESOLUTION

tabled by Mr WELSH, Mr GAUTIER, Mrs GREDAL, Mr LANGE, Mr MOREAU, Mr BLUMENFELD, Mrs MOREAU, Sir Fred CATHERWOOD, Mr PROVAN, Mr SPENCER, Mr TYRRELL, Mr DELOROZOY and Mrs VEIL

for entry in the Register
pursuant to Rule 49 of the Rules of Procedure

on taxation of companies by American States

THE EUROPEAN PARLIAMENT

A. Noting that a number of American States have adopted a world wide system of taxing companies on an imputed percentage of their profits known as Unitary Tax, effectively taking profits earned outside the USA,

B. Aware that the US Supreme Court has accepted the legality of such a system for domestic US corporations,

C. Concerned that this decision may be taken to extend to American companies with subsidiaries in Europe and the American subsidiaries of Community based companies,

1. Considers that the principle of Unitary Tax is contrary to the spirit of the various double taxation treaties and discriminates unfairly against European based companies with operations in the United States.
2. Regrets that the United States Administration did not file an Amicus Curiae Brief in the Supreme Court case of Container Corporation of the US vs. California Trustees which would have enabled the position of overseas Companies to be clarified.
3. Urges the Administration to give full hearted support to legislation before the Congress which would exempt overseas Companies from this discriminatory form of tax.
4. Urges the Commission to instruct its Delegation in Washington to continue to press this matter which can only damage relations between the Community and the United States to the detriment of their mutual economic and political interests.
5. Believes that failure by the Administration and Congress to act in this way would justify the suspension of the double taxation treaties by the Member States.
6. Instructs its President to forward this resolution to the President of the Commission, the Head of the US Mission to the European Communities and the Chairman of the Delegation of the US Congress to the European Parliament.

EXHIBIT 34

Wednesday
10 July 1985

Volume 82
No. 152

8

HOUSE OF COMMONS
OFFICIAL REPORT

PARLIAMENTARY
DEBATES
(HANSARD)

Wednesday 10 July 1985

LONDON
HER MAJESTY'S STATIONERY OFFICE
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NEW CLAUSE 27

WITHDRAWAL OF RIGHT OF CERTAIN NON-RESIDENT COMPANIES TO PAYMENT OF TAX-CREDITS

(1) This section applies to a company which has, or is an associated company of a company which has, a qualifying presence in a unitary state and, at any time when it or its associated company has such a qualifying presence, is entitled by virtue of arrangements having effect under section 497(1) of the Taxes Act (relief by agreement with other countries) to a tax credit under section 86 of the Finance Act 1972 (tax credit for certain recipients of qualifying distributions) in respect of qualifying distributions made to it by companies which are resident in the United Kingdom which is equal to one half of the tax credit to which an individual resident in the United Kingdom would be entitled in respect of such distributions.

(2) Schedule (*Supplementary provisions as to withdrawal of tax credits*) to this Act has effect to supplement the provisions of this section.

(3) Notwithstanding anything to the contrary in the arrangements referred to above and subject to paragraph 2 of the said Schedule, a company to which this section applies shall not be entitled to claim under subsection (4) of the said section 86 to have the tax credit referred to in subsection (1) above set against the income tax chargeable on its income for the year of assessment in which the distribution is made or, where the credit exceeds that income tax, to have the excess paid to it.

(4) A company shall be treated as having a qualifying presence in a unitary state if it is a member of a group and, in any period for which members of the group make up their accounts ending after the relevant date, 7½ per cent, or more in value of the property, payroll or sales of such members situated in, attributable to or derived from the territory outside the United Kingdom, of which that state is a province, state or other part, are situated in, attributable to or derived from that state.

(5) For the purposes of subsection (4) above —

(*a*) 7½ per cent. or more in value of such property, payroll or sales as are preferred to in that subsection shall be treated as being situated in, attributable to or derived from the state there referred to, unless, on making any claim under sub-section (4) of the said section 86, the claimant proves otherwise to the satisfaction of the Board, and

(*b*) the value of the property, payroll or sales of a company shall be taken to be the value as shown in its accounts for the period in question and for this purpose the value of any property consisting of an interest in another member of the group or of any sales made to another such member shall be disregarded.

(6) In this section "the relevant date" means the date on which this section comes into force or, if earlier, the earliest date on which a distribution could have been made in relation to which the provisions of this section are applied by an order made under this section.

(7) This section shall come into force on such date as the Treasury may by order made by statutory instrument appoint and the Treasury may in addition by order made by statutory instrument —

(*a*) prescribe that the provisions of this section shall apply in relation to distributions made on or after a date before that on which the order bringing them into force is made, being a date not earlier than 1st April 1985.

(*b*) prescribe those provinces, states or other parts of a territory outside the United Kingdom which are to be treated as unitary states for the purposes of this section, and

(*c*) prescribe that for subsections (4) and (5) of this section (or for those sub-sections as they have effect at any time) there shall be substituted either the following provisions —

"(4) A company shall be treated as having a qualifying presence in a unitary state if it is subject to tax in such a state for any period ending after the relevant date for which that state charges tax.

(5) For the purposes of subsection (4) above a company shall be regarded as subject to tax in a unitary state if it is liable there to a tax charged on its income or profits by whatever name called and shall be treated as so charged unless it proves otherwise to the satisfaction of the Board.".

or the following provisions —

"(4) A company shall be treated as having a qualifying presence in a unitary state if it has its principal place of business in such a state at any time after the relevant date.

(5) For the purposes of subsection (4) above

(*a*) a company shall be treated as having its principal place of business in a unitary state unless it proves otherwise to the satisfaction of the Board, and

(*b*) the principal place of business of a company shall include both the place where the central management and control of the company is exercised and the place where the immediate day-to-day management of the company as a whole is exercised."

(8) No order shall be made under this section unless a draft if it has been laid before and approved by a resolution of the Commons House of Parliament.".— [*Mr. Grylls.*] *Brought up, and read the First time.*

Mr. Michael Grylls (Surrey, North-West): I beg to move, That the clause be read a second time.

Mr. Deputy Speaker (Sir Paul Dean): With this it will be convenient to take amendment No. 57 — new schedule —

'SUPPLEMENTARY PROVISIONS AS TO WITHDRAWAL OF TAX CREDITS

'Recovery of tax credits incorrectly paid

1. — (1) Where the provision of section [*Withdrawal of rights of certain non-resident companies to payments of tax credits*] of this Act apply so as to withdraw the entitlement of a company to claim to have a tax credit in respect of a qualifying distribution set

against the income tax chargeable on its income and to have the excess of the credit over that income tax paid to it and the company (in this paragraph referred to as "the recipient company") has either had that excess paid to it, or has received an additional amount in accordance with arrangements made under Regulation 2(1) of the Double Taxation Relief (Taxes on Income) (General) (Dividend) Regulations 1973, it shall be liable to a fine for the violation of the provisions of section [*Withdrawal of right of certain non-resident companies to payment of tax credits*] of this Act equal to twice the amount of the excess or additional amount as the case may be and such fine (in this section referred to as "the recoverable amount") shall be payable to the Board and treated as having become payable at the date when the excess or additional amount was paid to the recipient company and may be recovered in accordance with subparagraphs (2) to (5) below.

(2) The recoverable amount may be assessed and recovered as if it were unpaid tax and section 30 of the Taxes Management Act 1970 (recovery of overpayment of tax, etc) shall apply accordingly.

(3) Any amount which may be assessed and recovered as if it were unpaid tax by virtue of this paragraph shall carry interest at the rate of 9 per cent. per annum from the date when it was payable in accordance with this paragraph until the date it is paid and it is hereby declared that this paragraph applies to a recoverable amount which is paid without the making of an assessment (but is paid after it is due) and that where the recoverable amount is charged by any assessment (whether or not any part of it has been paid when the assessment is made), this paragraph applies in relation to interest running before, as well as after, the making of the assessment.

(4) Where the recoverable amount is not paid by the recipient company within six months from the date on which it became payable —

(*a*) the recoverable amount may at any time within six years from the date on which it became payable be assessed and recovered as if it were unpaid tax due from any person who is or

was at any time prior to the expiration of the said six year period connected with the recipient company, or would have been connected on the assumption that all the facts and circumstances relating to the recipient company at the time the excess or additional amount as the case may be was paid continued to apply for six years thereafter, and section 30 of the Taxes Management Act 1970 shall apply accordingly, and

(*b*) as respects its accounting periods beginning with that in which the excess or additional amount referred to in sub-paragraph (1) above was paid and ending with that following that in which the recoverable amount is paid in accordance with the provisions of this paragraph, the company which made the qualifying distribution in respect of which the recipient company received the excess or additional amount shall not be entitled to set any advance corporation tax paid by it against its liability to corporation tax for such periods in accordance with section 85 of the Finance Act 1972 (payments of advance corporation tax to be set against company's liability to corporation tax on its income) nor to surrender the benefit of the whole or any part of any amount of advance corporation tax to a subsidiary in accordance with section 92 of that Act (*setting of company's surplus advance corporation tax against subsidiary's liability*) in such periods.

(5) Where a recoverable amount is assessed and recovered from a person connected with the recipient company in accordance with sub-paragraph (4)(*a*) above, that person shall be liable for the interest payable in accordance with sub-paragraph (3) above and, until the interest is so paid, sub-paragraph (4)(*b*) above shall apply as if the words "the interest due in accordance with sub-paragraph (3) above is paid" were substituted for the words "the recoverable amount is paid in accordance with the provisions of this paragraph".

(6) Interest payable under this paragraph shall be paid without any deduction of income tax and shall not be allowed as a deduction in computing any income, profits or losses for any tax purposes.

(7) Where under the law in force in a territory outside the United Kingdom interest is payable subject to a deduction in respect of taxation and such deduction applies to an amount of interest paid in accordance with sub-paragraph (3) above, the reference to the rate of 9 per cent. per annum in that sub-paragraph shall be deemed to be a reference to such rate of interest as after such deduction shall be equal to the rate of 9 per cent. per annum.

Claims to payment of tax credits following remedial legislation in unitary states

2. — (1) This paragraph has effect where a company to which section [*Withdrawal of right of certain non-resident companies to payment of tax credits*] applies has a qualifying presence in a province, state or other part of a territory outside the United Kingdom which has been prescribed as a unitary state for the purposes of that section and, at the time when a qualifying distribution is made to that company by a company which is resident in the United Kingdom, that state has enacted legislation the effect of which is that, as from a future date which shall not be later than 31st December 1986, it will cease to be a unitary state within the meaning of the definition in paragraph 5(1) below, notwithstanding that it remains prescribed as such for the purposes of that section.

(2) In the circumstances described in sub-paragraph (1) above the company in receipt of the qualifying distribution shall be entitled on or after the effective date to claim to have the tax credit to which it is entitled in respect of the distribution set against its liability to income tax and to have the excess (if any) of the credit over that liability paid to it: but, if payment of the excess or of the additional amount referred to in Regulation 2(1) of the Double Taxation Relief (Taxes on Income) (General) (Dividend) Regulations 1973 is made before the effective date, the provisions of paragraph 1 above shall apply in relation to that payment regardless of the enactment of the legislation referred to in sub-paragraph (1) above.

(3) For the purposes of this paragraph the effective date shall be deemed to be the date (not to be later than 31st December 1986) on which the legislation referred to in sub-paragraph (1) above actually becomes effective in the province state or other Kingdom multinational group, although that has no conceivable relevance to the group's activities in the United States, and in that state in the United States.

That reporting system makes a nightmare of business planning and investment by multinationals, by creating uncertainty as to the tax due in a state such as California. I ask the House to consider the situation in a London headquarters company with a subsidiary in California, which is therefore subject to Californian unitary tax. That subsidiary in California cannot know its tax liability without supplying the state authorities with such details as payroll, property and equipment in every other country throughout the world in which that British multinational operates.

The House may be interested to have an example, which brings the matter home. It is the case, which has been well written up, of the subsidiary of the EMI group, Capitol Records. It is in California, and now part of the Thorn EMI group. The Capitol Records subsidiary was asked to provide information on a worldwide reporting basis. It sent that request from the Californian state authorities to its headquarters in London, which wrote to the Californian state authorities saying, "We would love to give you this information, and would normally be happy to do so, but we happen to be a defence contractor for Her Majesty's Government, and we have signed the Official Secrets Act. If we give you this information, we shall be put in prison, so we shall not do it, even for the Californian tax authorities." The company then suffered a 25 per cent. penalty clause for non-disclosure of information from London and other parts of the world. That illustrates the unpredictability and irrationality of such taxation.

The sheer unpredictability and illogicality of such a method of tax assessment threatens investment and trade. Above all, it strikes a blow at the internationally accepted principles of taxation by creating tax liabilities in a state which bear no direct relation to profits earned in that state. For the purposes of state taxation, the method can turn a company's loss in a state into a profit by

bringing in the worldwide figures. Perhaps more seriously, it burdens companies with the unproductive work of creating and producing information and translating it into dollars from the foreign currencies in which those subsidiary companies operate. That is not sensible. An example of this is that the worldwide accounts of companies must be recomputed in dollar terms and must conform to American accounting standards. That is especially offensive when a state — a political subdivision of a nation — attempts to carry out what is, in effect, foreign policy. I am sure that those who created the constitution of the United States did not intend that the individual states should carry out foreign policy by asking for information in that way.

To draw an analogy closer to home, it is as though Lambeth borough council asked for worldwide information from an American company whose United Kingdom subsidiary was based in Lambeth. That would be an impertinence and an abuse of the powers of Lambeth borough council. I am sure that it would do no such thing. That is comparable with what is happening in some American states. It runs counter to all the work that has been done. Through double taxation treaties, the United States and Britain have worked for many years to eliminate barriers to trade and investment, which were created, understandably, by the variety of tax systems in the world. The arms-length system of taxation embodied in our treaty network and that of the United States is the international standard and the custom of nations. It is recognised by the OECD and by the United Nations. The use of the worldwide reporting system violates that standard.

I should run through what has happened since the United Kingdom-United States treaty was being negotiated in 1975, because the history of what happened is the basis of new clause 27. When the current treaty was being negotiated in 1975, it contained a clause — clause 9(4) — which would effectively have barred unitary tax. That would have been fine. Unfortunately, although clause 9(4) was passed by a majority in the Senate, it was not passed by the necessary two thirds majority, and it failed. By this American action, Britain was placed in the position of either rejecting the entire treaty — some would describe that as throwing out the baby with the bathwater — or of

accepting it without clause 9(4). The House, rightly, accepted the treaty, subject to assurances from Ministers that they would press for an early resolution of the issue, backed by assurances from the United States that it would use its best endeavours to secure an early solution.

On 18 February 1980, the then Minister of State — my right hon. and learned Friend the present Chief Secretary — said:

"To those who remain concerned about the unitary question, I say that there is no disposition on the part of the Government to let the issue die. If the house approves the convention and if it is ratified thereafter, we shall be prepared to place on record, for all to see, our reservations on the unitary system. The Administration of the United States were left in no doubt by what I told them . . . We do not propose to bury the issue if the House gives its approval to the convention and the three protocols." — [*Official Report*, 18 February 1980; vol. 979.c. 179-99.]

When ratification took place on 25 March 1980 — entering into force on 25 April 1980 — the British Government expressed to the United States Administration strong disapproval of the world-wide combined reporting system. In a note to the United States Administration, the Government said:

"It must be emphasised however that the acceptance of the Senate reservation" —

taking our clause 9(4) —

"in no way implies approval of the unitary basis and that it is the urgent request of Her Majesty's Government for the reasons given above that the Government of the United States should use its best endeavors to eliminate the international application of the unitary basis of taxation".

United States' companies received substantial tax concessions as a result of the treaty in return for the inclusion of clause 9(4) prohibiting the use of unitary tax. Clause 9(4) was to be, in the words of the then Senator Morgan, who participated in that debate in the Senate, "a concession for a concession".

I believe that in 1980 the House would not have ratified the treaty without United States' assurances that the unitary tax problem would be solved.

Since 1980 there have been various attempts in the United States Congress, as my colleagues who visit the United States regularly will know, to put through a Bill outlawing unitary tax. It is odd that, despite general antipathy in Washington towards this unfair system, so far none of these Bills has succeeded in being passed. It seems that, whenever a Bill has approached the winning post, another general election has been called, and the whole process has had to start again. I suppose that we have the same problem here. During this period the United Kingdom Government and many other Governments have pressed vigorously for an end to this perverse system.

I should like to pay a warm tribute to the staff of the British embassy in Washington who, over these five or Kingdom multinational group, although that has no conceivable relevance to the group's activities in the United States, and in that state in the United States.

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this information and would normally be happy to do so, but we happen to be a defence contractor for her Majesty's Government, and we have signed the Official Secrets Act. If we give you this information, we shall be put in prison so we shall not do it, even for the Californian tax authorities." The company then suffered a 25 per cent. penalty clause for non-disclosure of information from London and other parts of the world. That illustrates the unpredictability and irrationality of such taxation.

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I should like to pay a warm tribute to the staff of the British embassy in Washington who, over these five or seven years, have worked hard to resolve this issue. I pay particular tribute to the Economic Secretary in the embassy, Mr. Harry Walsh, who has

just returned to London. He had become one of the great experts there. He slaved away on this issue and worked tirelessly to produce a solution. I should like to thank the British consulates at the state level which have negotiated and done what they can. I pay tribute also to Treasury Ministers and their officials in the United Kingdom, in the Foreign and Commonwealth Office and especially in the Inland Revenue, who have borne the burden of this continuing problem.

Two years ago on 12 July 1983 my right hon. Friend the Chancellor in a letter to the then Treasury Secretary, Donald Reagan, said that he was

"keen for the matter to be resolved . . . before harm is done between our two countries."

I emphasise that quotation, because hon. Members and all the British people do not want in any way to damage our relations with our strongest and, perhaps, favourite ally. I think that my right hon. Friend the Chancellor had that point very much in mind. However, the problem has not been resolved.

In September 1983 President Reagan set up a working group to look into the problem. The Prime Minister, who was visiting Washington at that time, chivvied the President to resolve the issue and, with commendable farsightedness, warned the Administration:

"We might be under very severe pressure to take retaliatory action."

Two years later we find ourselves having to do just that.

12.15 am

I pay tribute also to the efforts of my right hon. Friend the Secretary of State for Trade and Industry. He lobbied for industry during his recent visit to California and I know that was helpful.

By the autumn of 1983, despite all the efforts that had been made, three years had passed and the promises of 1980, which I have quoted, to resolve the issue had not been met. Frustration and impatience were being expressed in Westminster and British firms were becoming increasingly caught up in a tax nightmare. I

hope that the House will feel strongly that it is our duty and that of the Government to protect the interests of individuals travelling abroad and those companies that operate abroad.

In April 1984, seven months later, there were no signs of progress from the United States working group. I went to Washington to announce details of a retaliatory clause that we had tabled last year. The clause had the support of many of my hon. Friends. Unfortunately, and I believe mistakenly, the Government refused to back the clause and to have a debate last summer, almost precisely at this time of year. They claimed that it was premature to retaliate.

There is no doubt that the tabling of the clause in 1984 alerted United States opinion to the real possibility of legislation being enacted in Westminster to retaliate against them. As a result of publishing the clause last year, there was evidence of fresh activity in the United States against the continuation of unitary tax. There were clear signs of United States companies working hard to get rid of it.

When the clause was not inserted in the Finance Bill 1984, it seemed that United States corporations saw that the threat of retaliatory action had receded. Later in 1984, the working group reported. It recommended what it described as a "water's edge" solution. At that time the United States Treasury Secretary wrote to the President as follows:

"If there are not sufficient signs of appreciable progress by the States in this area by 31st July next year whether by legislation of administrative action, I will recommend to you that the Administration propose federal legislation that would give effect to a water's edge limitation patterned after that in the Chairman's Report."

That was the result of the working group's activity.

I pay tribute to the states that have repealed their unitary tax provisions since then — including Oregon, Florida and Colorado — but it is important that during the debate the United States Administration is left in no doubt that the House does not regard the action by those states as being enough to constitute "apprecia-

ble progress" in removing unitary tax and that it does not constitute a real solution to the problem. It is not our job to pick off states one by one.

The problem will not be met until California and the other five unitary states have passed satisfactory legislation, or until the federal Administration has produced a solution that will stand for the whole United States. In many ways a federal solution would be the best one.

Over the past year, attempts — unfortunately all in vain so far — have been made in Sacramento, the state capital of California — to progress legislation on unitary tax. I am grateful to the governor of California for the personal efforts that he has made to seek a solution to the unitary tax problem. Only two weeks ago I went to California to see what progress was being made and, perhaps more importantly, to express the continuing anger and frustration of many in the House and in British industry that so little progress had been made.

United States business men whom I met, and Japanese business men, all told me that they wanted a solution to the problem. That view is shared by our European Community partners, especially the Netherlands, France and Germany, and by Japan, Canada and Switzerland. However, satisfactory legislation in one form or another still eludes us seven years after the treaty was signed and after assurances were given to the House of Commons. This House, which has been patient almost to a fault during that period, can no longer wring its hands and hope that something will be done. The time for action has come. We must apply leverage on the United States to secure a complete, satisfactory and final solution to this irritating problem. That is the reason for new clause 27.

Since the first retaliatory clause was tabled in 1984, extensive consultations have taken place with business and lawyers to try to provide in this new retaliatory clause a greater element of flexibility for the Government when deciding how widespread the United Kingdom countermeasures should be. When it is triggered by statutory instrument, the clause would withdraw payments of tax

credits to United States companies with a substantial business presence in unitary tax states — for example, California.

There are three options. Depending upon which of the three options the Government choose, the trigger will affect United States companies in the United Kingdom which have 7.5 per cent. or more of their property, payroll or sales in a unitary tax state, or which are subject to tax on income in a unitary tax state, or which have their principal place of business in a unitary tax state. Those are the three triggers that the Government will have at their disposal if the House decides to accept the new clause. My hon. Friend the Member for Tatton (Mr. Hamilton) who is a very experienced lawyer has been working with me on this new clause. He will expand a little further, if he catches your eye, Mr. Deputy Speaker, on the details.

The House will want to know what advice those hon. Members who have sponsored the new clause will be giving to the Government about when they should activate one of the three triggers. Such a decision will not be easy for my right hon. Friend the Chancellor of the Exchequer and his colleagues in Government. I pay tribute to them for having expressed considerable sympathy for the clause and for enabling this debate to take place. Rather like marriage, retaliation against a friend and ally is not something to be entered into lightly.

We must all hope that if this new clause is passed it will succeed in inspiring action in California and the other unitary tax states during the remaining few weeks of the 1985 legislative session. We must also hope that it will inspire action in Washington and that they will lobby the federal Government to use their influence to solve this problem. If they do not, I hope that my right hon. Friend the Chancellor of the Exchequer will not flinch from pulling a trigger which will hit United States companies where it hurts: on their bottom line. That would produce a response.

If the new clause is successful in motivating the United States Administration, the states and business to secure a solution to this problem, the trigger could be released just as quickly as it had been pressed.

I pay tribute to the determination of the 50 companies which some years ago formed themselves into the unitary tax campaign which has worked very hard to solve this problem. A number of the companies benefit from the application of unitary tax. Despite that, they believe that the principle is wrong and they vigorously oppose it. I pay tribute to them for their stand. I pay tribute also to the chairman of the unitary tax campaign, Mr. Peter Welch, and to Professor Peter Whiteman, QC, a highly skilled lawyer who has helped us to draft the new clause. If the new clause is accepted, the House will owe him a great debt. The CBI, too, should be praised for its action in sending a mission earlier this year to California.

Although I have criticised the Government for resisting the pressure for retaliation in 1984, I am the first to say that the Government, including the Chancellor, the Foreign Secretary and the Financial Secretary, have shown admirable resolution and determination in pressing for a solution to the problem. I hope that the House will approve the new clause and that the Financial Secretary will agree that the time has come to put these powers on to the statute book.

Dr. Marek: I was interested in the remarks of the hon. Member for Surrey, North-West (Mr. Grylls) and to hear the long roll call of people who have been involved in the campaign and the various actions that they had taken to arrive at the position which we are discussing tonight.

However, missing from the hon. Gentleman's comments was any justification from the point of view of, say, California as to why that state felt that it had no option other than to institute unitary taxation. The hon. Gentleman said that such taxation could, in a particular example, change a loss into a profit. That may be so from an examination of the company's books, but it may not be so from a careful examination of whether transfer pricing between different parts of the company — remembering that we are talking about multinationals — has taken place between one country and another. That is the problem facing us as we consider the new clause.

Companies do not have a code of morality and say, "We honestly believe that we made 20 per cent. of our profits as a multinational in the United Kingdom, so we will pay 20 per cent. of the tax to the UK, and the respective rates of tax in all the countries in which we operate." Multinationals will, by and large, try to minimise the tax that they pay worldwide, and rightly so. If, say, in California wage rates, land taxes or whatever are high, multinationals will minimise the tax that they pay in California and maximise the tax that they pay in, say, Taiwan and Korea. The same is true of multinationals based and registered in this country.

For a company that is based in this country and has much of its business in America, it gets caught by way of unitary taxation, and there is a real problem for such companies. There is an inherent unfairness in a system by which some states apply the normal code of taxation and others apply unitary taxation because, in effect, that creates double taxation, and that hits particularly hard those companies which are registered in, say, the UK but have a substantial trading interest in a country which applies unitary taxation, such as California. It is clear, therefore, that the system is not fair. For that reason I hope that the new clause will be accepted.

However, price fixing and transfer pricing by multinational companies operates not to the benefit of this country. It is not to the benefit of this county. Having said that, I do not think that affects the issue of unitary taxation. It ought to be looked at but not now.

I wish the new clause well. We cannot have two systems working side by side. We will either have to have one or the other. We do not have unitary taxation, there is no prospect of it coming, therefore it is sensible to see if we can get rid of it.

12.30 pm

Sir Eldon Griffiths (Bury St. Edmunds): I very rarely speak in finance debates. I am quite sure that the rule of the road should be brevity, but I have perhaps some small credentials to speak in this matter because I have spent virtually the whole of my

political and personal life as a devotee of the United States. I went to college there. I earned my living there for some 17 years. I bought my first house there. I was married there. I have a son there who is a banker. I am a director of two American companies. I visit the United States many times each year and I have the honour of representing, indirectly no doubt, some 23,000 American airmen who have the good fortune to be stationed in my constituency. So I make no bones about it. The United States is my second home and my dearest wish in politics is that the Anglo-American alliance shall continue to be the bulwark of freedom and prosperity in the western world.

But there is one thing that I have never been able to stand when it comes from the United States and that is the attempt occasionally to export American policies beyond the water's edge and to impose them on other people. They tried that at the federal level in respect of the Soviet Federal Government have shown a certain sensitivity over this, or at least that has been the stated reason for slow progress, but the Federal Government must make far greater use of the opportunity they have to bring pressure to bear on the states to change.

Two events which occurred in 1983 are worth mentioning. First of all, there was the decision in the Container Corporation case, where the Supreme Court of the United States determined that unitary taxation was not outlawed by the constitution. But that was a majority decision with a strong dissent, and the United States Justice Department was not briefed to appear in that case but attempted to appear after it ended. The commission set up by Secretary Regan, which reported in July 1984, looked at the matter in a certain way. In particular it recommended that unitary taxation should be restricted to the water's edge; in other words, confined to taxing as a unit a company's activities within the United States.

According to the Unitary Taxation Campaign, there are still nine states with unitary taxation, which means that they go across the water's edge. There seems to be some disagreement as to the precise number of states. Some Treasury Ministers put the figure at six and the Library told me it was seven. Perhaps the Financial Secretary could elucidate on that. When the Regan commission

reported, it set a deadline of 31 July 1985 for the states to take action on unitary taxation. That deadline is fairly close now, and I hope that this new clause, if it is passed, will give the Government a negotiating weapon. It will be a sign of our seriousness of intent to allow the federal and state governments to recognise exactly what we are contemplating.

New clause 27 meets the injustice of unitary taxation with the fairly rough justice of retaliation. Were a state to be designated by an Order of the House, any company with a qualifying presence within that state would not be able to claim back the refund of ACT under the double taxation treaty. That is a fairly heavy penalty for those companies with a qualifying presence in that state to bear. One hopes that that will encourage them to put pressure on their own state Governments to change their attitude towards unitary taxation.

It is right that the House will have to approve an order before the new clause can come into operation. We are expressing the seriousness of our concern, but we are saying, "We do not want to go all the way until they have had another chance to put their house in order." The new clause will force the pace towards abolition of unitary taxation.

12.45 am

The British Insurance Association and a number of insurance companies are worried about the difficulties that could arise for them if the new clause is implemented. I should like an assurance from the Financial Secretary that their representations would be taken into account before it was decided to put an order before the House.

It is important that the new clause has all-party support and that the House is united in identifying the problem and in its desire to ensure that discrimination against British companies is prevented. If it is felt that an order should be put before us — we hope that the need for that will not arise — it would be wise for the Opposition to be kept fully informed of the state of play, so that the all-party support can be retained. It is important that we should act as one.

The issue is important to British firms. We hope that the United States Government and the state governments will note the strong feeling of both sides of the House and will act voluntarily, rather than wait for the threat of retaliation to become actuality.

Sir William Clark: I support my hon. Friend the Member for Surrey, North-West (Mr. Grylls). Like him, I have been battling for years against unitary taxation.

I wholeheartedly agree with the hon. Member for Sedgefield (Mr. Blair) that it is a great boost to our battle that the new clause has all-party support. The Financial Secretary would be wise to note the comments of the hon. Member and to stress to the United States Government that we are not making party points.

I am sorry that the hon. Member for Wrexham (Dr. Marek) brought in multinational companies. We do not want to complicate the issue. We are talking about unitary tax and that has nothing to do with multinational companies.

The hon. Member for Sedgefield mentioned the worries of the British Insurance Association. It fears that if we take action against the United States the fourth convention will be cancelled. I cannot envisage that happening. The fears of the BIA are unfounded.

We are talking about an iniquitous tax which is anti-investment in the United States. We have well over $30 billion of investment abroad. As my hon. Friend the Member for Surrey, North-West said in a speech which everyone has commended for its clarity and lucidity, British companies own well over 20 per cent. of all foreign investment in the United States.

When I was in Washington before the presidential election I met Mr. McClure, the chairman of the working party set up by the President, and I told him in no uncertain terms what Back Benchers on both sides of the House thought of unitary tax. I warned him — and I am glad that the Prime Minister said much the same thing to the President — that pressure from both sets of Back Benches would be such that our Government would have to

give way eventually, whether on the next Budget or the one after that.

Here we are at the next Budget. The United States has not taken on board what unitary tax could lead to. There is a great deal of British and American investment in Third-world countries. If any country thinks it legitimate and good business to have unitary tax, it would be disastrous for overseas investment for both the United Kingdom and the United States. I accept that this is retaliatory action. We can control only what we control, and we control only advanced corporation tax. That means on a £100 gross dividend that instead of an American investor receiving £85, in future he will receive only £70 because he will not get the 50 per cent. reduction in ACT. That should be pressed home because the latest figures show that the ACT concession for the United States is well above £300 million. If American companies, which invest in the United Kingdom and receive British dividends, realise that their income is at risk, the Federal Government may come under more domestic pressure.

Two events which occurred in 1983 are worth mentioning. First of all, there was the decision in the Container Corporation case, where the Supreme Court of the United States determined that unitary taxation was not outlawed by the constitution. But that was a majority decision with a strong dissent, and the United States Justice Department was not briefed to appear in that case but attempted to appear after it ended. The commission set up by Secretary Regan, which reported in July 1984, looked at the matter in a certain way. In particular, it recommended that unitary taxation should be restricted to the water's edge; in other words, confined to taxing as a unit a company's activities within the United States.

According to the Unitary Taxation Campaign, there are still nine states with unitary taxation, which means that they go across the water's edge. There seems to be some disagreement as to the precise number of states. Some Treasury Ministers put the figure at six and the Library told me it was seven. Perhaps the Financial Secretary could elucidate on that. When the Regan commission reported it set a deadline of 31 July 1985 for the states to take action on unitary taxation. That deadline is fairly close now, and I

hope that this new clause, if it is passed, will give the Government a negotiating weapon. It will be a sign of our seriousness of intent to allow the federal and state governments to recognise exactly what we are contemplating.

New clause 27 meets the injustice of unitary taxation with the fairly rough justice of retaliation. Were a state to be designated by an Order of the House, any company with a qualifying presence within that state would not be able to claim back the refund of ACT under the double taxation treaty. That is a fairly heavy penalty for those companies with a qualifying presence in that state to bear. One hopes that that will encourage them to put pressure on their own state Governments to change their attitudes towards unitary taxation.

It is right that the House will have to approve an order before the new clause can come into operation. We are expressing the seriousness of our concern, but we are saying, "We do not want to go all the way until they have had another chance to put their house in order." The new unitary clause will force the pace towards abolition of unitary taxation.

I recognise that the Federal Government have difficulties in that the states are autonomous. On the other hand, if we had inserted the clause about outlawing unitary tax in 1975, it would have been mandatory on all the states because the sovereignty of the Federal Government in Washington means that they can sign an international agreement which binds all the states.

We must bring pressure to bear on the Washington Government to end this iniquity. We are approaching 31 July and we cannot allow the present position to continue. I earnestly hope that my hon. Friend the Financial Secretary will accept the clause, and that he and the Chancellor of the Exchequer will trigger off the three points made by my hon. Friend the Member for Surrey, North-West. That is the only way to bring home to the Americans that we mean business and that unitary tax must cease.

Mr. Pike: I shall speak only briefly because the hon. Member for Surrey, North-West (Mr. Grylls) argued the case well, and my hon. Friend the Member for Sedgefield (Mr. Blair) made the

points that I intended to make. I support the new clause because it takes the right line. It is unfortunate that the line that the Government have pursued for many years has been unsuccessful in achieving the result for which we have wished. If the Government accept the amendment and it is carried, I hope that it will not be necessary to trigger the lines of action proposed in the clause, and that the Government will not find it necessary to return to the House for an order to take retaliatory action. I hope that California and the Federal Government realise that we mean business and that we intend to ensure free trade.

My hon. Friend the Member for Wrexham (Dr. Marek) referred to multinational companies, but the hon. Member for Croydon, South (Sir W. Clark) took his comments out of context. The new clause has all-party support, as has the early-day motion, in spite of doubts among my right hon. and hon. Friends about multinationals.

I have some doubts and fears about multinationals, but I recognise the importance of the taxation rather than the trade issue. It is significant that, despite fears and worries, Opposition Members are prepared to support the early-day motion and the new clause. I hope that the new clause is accepted and that it is not necessary to trigger the orders. I hope that the California authorities in particular will wake up and realise that we mean business. The House as a whole is saying that if they do not, we shall, unfortunately, have to retaliate. We hope that we do not have to take that action.

Mr. Neil Hamilton: I have a small qualification to take part in the debate because, when the double tax treaty was about to be ratified back in 1979, I wrote a book on the topic — one of the few ways in which members of the Bar can draw their presence to the attention of solicitors. A few hundred copies of the book survive and can be obtained at discount rates. I never quite made the Jeffrey Archer class, so I never needed to take advantage of the provisions of the double tax treaty in relation to the international earnings which I received from that book.

The topic has concerned British industry for a long time, so it is important to examine the way in which the clause is drafted and

to discover why particular words are used rather than the alternatives which might have been used. It is important to recognise that this is merely enabling legislation which might never be used if the appropriate remedial action is taken.

As my hon. Friend the Member for Croydon, South (Sir W. Clark) said, the financial consequences of the new clause would be severe for many companies if we had to activate its provisions. It would deny tax credit equivalent to £15 on a £100 dividend to the parent company in the United States which would otherwise benefit from the repatriation of profits from United Kingdom subsidiaries.

The companies affected are those which have a substantial presence in the unitary tax state which operates the worldwide combined reporting system. The qualifying presence is defined as applying to a United Kingdom subsidiary which is a member of a group which has 7.5 per cent. or more of its property payroll or sales in a unitary tax state. That formula is used deliberately, because it is that which is used in the unitary tax states themselves and will therefore be familiar to companies oeprating there.

It is important to know that those firms' property payroll or sales are disjunctive and not conjunctive and therefore that if any one of them gives rise to the 7.5 per cent. trigger, the clause will affect all the companies which operate in that state. This is important to United States corporations because they already have to compile the information for state taxes. It is therefore available and will not involve any extra administrative costs to provide it to the Inland Revenue.

The 7.5 per cent. test could have been applied to income and we could have given ourselves extra lift, but we decided to reject that because conceptual problems might otherwise have arisen — such as whether we should choose gross or net income and whether it should be income for United States tax purposes or for the tax purposes of some other jurisdiction. It seemed much simpler to restrict ourselves to the tried and tested formula of the unitary tax states.

Why have we chosen 7.5 per cent.? Many right hon. and hon. Members have said that the main problem is California. I am

convinced that, if California takes the lead in getting rid of unitary tax, the other states will follow. California accounts for about 12.5 per cent. of American gross domestic product. That means that most American companies might come into the net if we have to activate new clause 27. Although, on that basis, the average company would have 12.5 per cent. of its assets in California, the figure pitched that high would have left many companies out of the net. We considered that the same was true for 10 per cent., so the next logical step seemed 7.5 per cent.

Why did we not go lower? In this respect, the other states that apply income tax come into play. The other states are small and there are few companies in the United States that would have more than 7.5 per cent. of their profit, payroll or sales in a state such as North Dakota. It seems that 7.5 per cent. is adequate to catch enough companies in California so that pressure can be put on the state legislature to remove the unitary tax provisions. If California repeals, the effect of the new clause is spent. Some states are not as legislatively busy as the rest of us. North Dakota, for example, has a lively system — its state legislature does not meet at all next year so, without a special session, it will be unable to conform to the new clause.

The onus of proof of entitlement to the tax credit for a company that would otherwise be caught by the new clause lies on the company, not the Inland Revenue. That means that the company must prove that it is not in the unitary tax net. It is not for the Revenue to dispute with the company its coming within the ambit of the clause, but for the company to prove that it can take advantage of the double tax treaty.

The Treasury should act early or, once again, people in California will assume that we are not serious and that this is just so much huffing and puffing. I do not think that the consequences that have been feared would necessarily follow from early action. Under subsection (7)*(a)*, the orders that the Treasury would have to lay can be backdated to 1 April 1985. That blocks any avoidance possibilities by which United States corporations could attempt to avoid the clause by repatriating massive dividends now and draining their subsidiaries in Britain of funds. As that is a possibility, but as we do not want to create too much uncertainty

in international trade, there should be as little retrospection as possible. We should therefore have action as quickly as possible.

There are two alternative figures to the 7.5 per cent. test to which I have already referred. One is a wide alternative trigger and the other is a narrow one. On the basis of the wide alternative the Revenue would be able to trigger the proposals in the new clause in relation to any company which has a qualifying presence in, for example, California by virtue of having any of its income subject to state taxes in that country. The narrower definition would mean that the principal place of business of the company should be in the unitary tax state. This gives enormous flexibility to the Revenue but also creates uncertainty. The states which operate unitary tax systems should realise that there is a wide battery of possibilities open to us and that we are determined that the new clause will be effective if it ever needs to be put into effect. That should encourage states to take early action to remove the cause of difficulty.

If by some mischance a company tries to evade or avoid the ambit of the new clause, a variety of penalties are provided in the new schedule. A fine could be levied equal to twice the tax credit. This type of fine is important as it entails the company not just repaying the tax credit that it has already received but suffering a fine equivalent to the tax credit plus an equivalent amount on top. That is important because, under the internal revenue code of the United States, fines are not deductible from corporate profits for tax purposes, so it would increase the cost to US corporations attempting to avoid or evade the new clause.

Interest is set at the rate of 9 per cent. under paragraph 1(3) of the new schedule, effective from the time when the tax credit is paid. The loss of the right to settle is covered in paragraph 1(4)*(b)*, which provides for a loss of the right to settle advance corporation tax on the dividend which cannot then be set against mainstream corporation tax liability. The right to settle is not only lost for the accounting period in which the tax credit is paid to the company but can be carried forward indefinitely if there is any excess or surplus available for that purpose.

Various avoidance techniques might be used to try to get around the working of the clause but I believe that we have effectively prevented them from succeeding. For example, what would happen if the United States parent company refused to pay the fine? Paragraph 1(4)*(a)* of the new schedule provides that the fine can be recovered from the United Kingdom subsidiary or from any connected company. What if the United Kingdom subsidiary pays the dividend and the parent company then liquidates the subsidiary to try to circumvent the clause? The liquidated company is deemed to exist for a further six years and if a new subsidiary is formed in its place within six years that company will be liable for the accumulated fines in relation to the original infraction. Thus, both simple liquidation and liquidation followed by reincorporation will be ineffective.

If a United Kingdom subsidiary or connected company pays the interest or the fine on behalf of the United States corporation, that will not be deductible for corporation tax purposes in this country. The purpose of that provision is to recapitulate for our own tax regime the effect of a fine not being deductible for tax purposes under the American internal revenue code.

The United States parent company subjected to fines and interest will have to pay the interest gross whereas normally the withholding of tax is deducted first and the interest is paid to the recipient net. That, too, will reduce the benefit of attempting to avoid the purposes of the clause.

The hon. Member for Wrexham (Dr. Marek) and others have referred to the use of creative accounting techniques, but I believe that we have prevented the use of such techniques by paragraph 3(1) of the new schedule. For example, if a United States parent company lends a United Kingdom subsidiary, say $1 billion and then charges 10 per cent. interest on the loan as a notional transaction intended to convert what would otherwise have been paid by way of dividend to a payment by way of interest, that too will be covered because the new schedule provides that interest paid where it is reasonable to suppose that a qualifying distribution would otherwise have been made will not avoid the provisions of the new clause.

The draconian powers of inspection and requirement of information in paragraph 4 are based on the controlled foreign companies provisions rushed through the House last year without debate and with the connivance of the Opposition, so I hope that both Front Benches will approve of that insertion of those provisions.

The measure that we propose is draconian, but desparate diseases require desperate remedies and that is the situation in which we now find ourselves. I repeat, however, that the effect of the new clause can be avoided by timely action by the states concerned. If repealing legislation is passed by 31 December 1986, even if the new clause is put into effect in the meantime, the United States corporations affected will get their 15 per cent. tax credit and will be no worse off than they now are even if the repealing legislation was not in force when the distribution payment was made. I believe that that will be a great incentive to action by California and I hope that the authorities there will take the hint.

It may be argued that we are setting a precedent, but I believe that the United States has already set the precedents. For example, the United States double tax treaty with France came into being as a result of a threat of retaliatory action of the kind that we propose today. Section 891 of the American internal revenue code sets that out, so in a sense we are simply following the action of the United States and not setting a precedent of our own.

It may be argued that our proposal overrides the double tax treaty and that that itself is a precedent. If the proposals were triggered off, they would certainly override the provisions of that treaty, but there are precedents for that in the United States. For example, the Foreign Investment in Real Property Tax Act 1980 which became effective on 1 January this year specifically overrides all the double tax treaties entered into by the United States with all countries around the world. The Americans have thus introduced domestic legislation of their own which overrides international obligations entered into freely by treaty; and that was a unilateral move on their part.

In relation to our own double tax treaty, too, the United States has overridden one of the articles. There is therefore a precedent for action in that context, too, in so far as the American Internal Revenue Service has made a ruling which overrides the provisions of the treaty in relation to insurance premiums received by United Kingdom insurance companies.

I believe, therefore, that this measure is timely and necessary. I do not believe that it will lead to retaliation by the United States. I believe that the Federal Government are determined to see an end to this problem in the interests of their own international trade and that the cost to United States companies of inaction by the Californian authorities will be very great indeed. If the Government support the new clause today they will do a great service not just to the cause of business in this country but to the whole international trading and business community.

I commend the new clause to my hon. Friend the Financial Secretary and I hope that what he has to say today will be trumpeted across the Atlantic as a meaningful and determined attempt to declare war upon a system of taxation which is as unjust and damaging to the interests of the United States as it is to the interests of this country and of all other countries affected by it.

1:15 am

Mr. Wrigglesworth: I support the motion, and urge others to support it. It is timely, as the hon. Member for Tatton (Mr. Hamilton) said. Some would say that it is long overdue. When the tax treaty came before the House, we had the opportunity to exert considerable pressure on the Administration, and, through the Administration, upon the states in the United States, to rectify the situation that had arisen. Although assurances were given, action did not result to the extent that we had hoped.

I have come firmly to the conclusion that only this sort of retaliation will pay the dividends that we want. In the mid-1970s I remember discussing the matter with Governor Brown in California and trying to get him to see the sense of the argument that was being put to him. It was clear that he was not going to budge

an inch, and that no other state government would, unless there was a clear reason for them to do so, in responding to their own electorate and their interests. The only way in which we can bring that about is by putting on the pressure proposed in the new clause.

Therefore, I hope that the House will give its full support to the new clause and that the Government will enthusiastically welcome it as a means to put pressure upon the Federal Government and through them on the state legislature, so that this ridiculous situation can be resolved.

Mr. Moore: I shall try to be brief, but the House will understand that it is essential that I express with great care and clarity the Government's attitude to the clause.

This has been a major debate on an issue of great importance to the United Kingdom, the United States and all our trading partners. If I may say so, the speech of my hon. Friend the Member for Surrey, North-West (Mr. Grylls) was fully in keeping with the importance of the issue. The House is indebted to him and his colleagues — I specifically mention my right hon. Friend the Member for Taunton (Sir E. du Cann), who is not with us tonight but who has been long active in the campaign, and my hon. Friends the Member for Croydon, South (Sir W. Clark), for Bury St. Edmunds (Sir E. Griffiths), and for Tatton (Mr. Hamilton). It is important that on the issue we have had consistent all-party support. I particularly welcomed the speech by the hon. Member for Sedgefield (Mr. Blair), representing the official Opposition, that of the hon. Member for Stockton, South (Mr. Wrigglesworth), and the continued presence throughout the debate of the hon. Member for Roxburgh and Berwickshire (Mr. Kirkwood). It is crucial that we have a clear signal on whatever we do in the area. The consistent all-party support has been a key feature of the debates on the issue.

It is clear that my hon. Friend the Member for Surrey, North-West spoke for the whole House when he referred to the widely felt frustration that a solution to the problem has been so long delayed. It is equally clear that he spoke for the House when he said that the time had come for Parliament to take legislative

action to register the United Kingdom's determination to see that a solution of the problem is achieved in the United States. That was borne out by contributions to the debate from all parts of the House. It is reinforced by the number of hon. Members — again from all parts of the House — who have put their names to the new clause on the amendment paper.

I should like to make it clear that the Government strongly endorse everything that has been said in the debate about the imposition of unitary taxation on United Kingdom-controlled companies and other non-American corporations.

The basic objection to unitary tax is that it is contrary to the internationally accepted principle for allocating profits where a company or group operates internationally. That is that tax authorities charge tax on foreign-owned companies only on the profits arising in the country or state for which they are responsible. The arm's-length method is recognised by both the Organisation for Economic Cooperation and Development and United Nations, and is enshrined in a worldwide network of bilateral double taxation treaties including the treaties to which the United States is party. It provides a coherent and consistent tax framework for international trade and investment.

As applied by states such as California, the unitary tax method applies a formula apportionment to the worldwide profits of a multinational group to establish the tax due in California. In doing so, a unitary state is reaching beyond the borders of its own jurisdiction and taxing profits earned outside it, and thus breaching the internationally accepted principles.

For individual companies, as many hon. Members have said, that means unfair tax bills and excessive compliance costs. It can also produce double taxation. Income earned by the foreign parent of a United States subsidiary is taken into account in the unitary tax bill, and taxed without any relief for overseas tax. Multinational groups can be taxed on more than 100 per cent. of their income in a particular state, and a loss can be turned into a taxable profit. Another serious objection is the excessive compliance burden imposed by worldwide unitary tax. The method inevitably involves financial information on the worldwide activities of the group, which can be extremely burdensome in practice. It is objectionable that a state tax authority should demand information about the financial records of United Kingdom companies, and their subsidiaries, which are outside the United States and unrelated to activities within the United States.

If unitary tax continues, it will distort investment decisions. The immediate effect is to damage inward investment in the states that impose it. There is increasing recognition in the United States that it is, therefore, in the economic interest of such states to remove it.

The damage goes wider than that. If unitary tax continues, it will disrupt the internationally accepted taxation framework, and have a damaging effect on the development of world trade. The importance of a solution is, therefore, self-evident.

A speedy resolution of the problem is especially important to the United Kingdom, because the cumulative total of United Kingdom investment in the United States is now more than $32 billion. This is more than any other country and represents nearly a quarter of all foreign direct investment in the United States. In 1983 alone, the United Kingdom invested more than $3.7 billion in the United States, which accounted for 32 per cent. of the total of foreign direct investment in the United States in that year.

The American Administration recognised this as long ago as 1977, when the United Kingdom and America negotiated a provision in the tax treaty to prevent individual states from applying the unitary method to United Kingdom companies. The proposed treaty was ratified by the House of Commons in 1977. However, article 9(4) was rejected by the United States Senate in 1978. The United Kingdom Government were then assured that the United States Administration would use their best endeavours to secure a solution.

Since then, there has been some progress, but not enough. There was a major setback as the hon. Member for Sedgefield (Mr. Blair) said, when the United States Supreme Court ruled in the Container case that the California worldwide unitary method

was not unconstitutional, at least so far as it was applied to a United States parent corporation and its foreign subsidiaries.

However, a working group was set up under the then Treasury Secretary Regan to seek to resolve the issue. The group reached a consensus on the general principle that unitary taxation should be limited to the United States water's edge. But it left important issues on the application of that general principle unresolved. In his Report to the President in July 1984, Secretary Regan said that these issues should be left for resolution at state level. However, he also said that if there were not,

"sufficient signs of appreciable progress by the states,"

by 31, July 1985, he would recommend to the President that the Administration propose federal legislation to give effect to a water's edge limitation.

It is right to recognise the importance that the United States Administration attaches to securing a solution, which will — as Secretary Regan put it — enable the United States,

"to speak with one voice in dealing with its foreign trading partners,"

so that,

"this irritant to international commercial relations will have been eliminated".

It is clear that there is a common objective. Some progress has been made at state level since the working group reported. Six states have now repealed or modified the worldwide application of unitary tax. But in some cases, the state legislation does not provide a comprehensive limitation on the application of unitary tax to United Kingdom groups. In five states, legislative initiatives have failed to succeed. In California, the key state to the United Kingdom, a legislative initiative last year was unsuccessful. Despite the Governor's efforts to achieve a solution and intense activity by key legislators, the chances of satisfactory legislation passing this year are in serious doubt.

It is against this disappointing background that the House must consider the legislation proposed in the clause and schedule.

Before we contemplate the passage of this legislation, we should ask whether we in the United Kingdom have done enough to impress on our friends in the United States the importance we attach to the issue. I think the answer must be yes. This has been confirmed by all we have heard in the debate. The Government have lost no opportunity to urge a speedy solution on the United States Administration, and have done so at the highest levels. The Administration have been well aware of the strong parliamentary pressure for legislative action if such a solution was not forthcoming. In the past year, when the focus has been on action at states level, there has been vigorous and concerted activity by the United Kingdom Government and industry. Government and industry teams have gone to Florida, Colorado, Utah and North Dakota in the past 12 months. Since last July, United Kingdom teams have visited California on four separate occasions. These included a major delegation led by Sir Terence Beckett of the CBI in February this year. I would like to pay tribute to the energy and resource displayed by the CBI, the Unitary Taxation Campaign — especially its chairman, Peter Welch — and other representatives of British business in trying to secure a resolution of the problem. As my hon. friend said, a similar tribute should be paid to our officials in the Embassy in Washington and in the other American consulates and, if I may say so, especially to our officials in the Inland Revenue.

Despite all this activity from the Government and industry, and from other countries, a resolution of the problem still remains in doubt. The Government have therefore concluded that it is right that the enabling powers proposed in the clause should be passed into legislation, and we so recommend to the House.

The hon. Member for Sedgefield (Mr. Blair) asked for two assurances. I happily give an assurance that the Government will take account of respresentations on behalf of the insurance industry, to which the hon. Gentleman particularly referred. Of course, that would extend to the rest of British industry. I recognise the absolute importance of obtaining all-party support. I cannot give an absolute undertaking in this matter, as clearly we cannot anticipate events and circumstances. However, I take the hon. Gentleman's comments very much into account. It is clearly

far better to retain a united parliamentary front. As the hon. Gentleman said, the House will have time to reflect and vote under the affirmative order procedure.

The powers in the clause and schedule, if invoked, would deprive United States parent companies of tax credit on dividends paid by their subsidiaries in the United Kingdom. They could have a major impact on the finances of such companies. At the extreme, they could cost these companies as much as £500 million a year.

The Government will not, of course, recommend to the House that these enabling powers should be invoked without the most careful consideration and consultation with all those concerned. It is important that if it becomes necessary to invoke the reserve powers there should be a degree of flexibility in specifying the companies and states that will be affected. My hon. Friend the Member for Surrey, North-West (Mr. Grylls) made a convincing case for this when he explained the changes that he has introduced into his clause to provide the maximum flexibility for the Government if a resolution were laid to bring the powers into effect.

I conclude, however, by expressing the earnest hope that it will prove unnecessary for the United Kingdom to invoke the reserve powers in the clause. I very much hope that our friends in the United States — in the Administration, the states and business — will soon be able to secure a satisfactory solution to the problem of their own volition. There is a common interest in solving the issue. The basis of that solution is common ground between the United States Administration, states and business. We trust that the United States will now be able to overcome the remaining obstacles to achieving a complete and enduring solution to this problem, by action in the states or by federal action.

In this spirit, I commend my hon. Friend's clause and schedule to the House.

Mr. Grylls: With permission, I should like to respond to the debate. I reiterate the all-party support for this measure. It is important that a signal should go to the United States that the House is determined in this matter and that the threat of

retaliatory action will not go away until the problem is solved. In that spirit, I hope that the house will accept the new clause.

Question put and agreed to.

Clause read a Second time and added to the Bill.

EXHIBIT 35

FINANCE ACT 1985

CHAPTER 54

LONDON
HER MAJESTY'S STATIONERY OFFICE
£10-40 net

FINANCE ACT 1985

CHAPTER 54

ARRANGEMENT OF SECTIONS

PART I

CUSTOMS AND EXCISE AND VALUE ADDED TAX

CHAPTER I

CUSTOMS AND EXCISE

The rates of duty

Interest, surcharges and supplements

18. Interest on tax etc. recovered or recoverable by assessment.
19. The default surcharge.
20. Repayment supplement in respect of certain delayed payments.

Assessments, records and information

21. Assessment of amounts due by way of penalty, interest or surcharge.
22. Assessments: time limits and supplementary assessments.
23. Amendments of Schedule 7 to the principal Act.

Appeals

24. Amendments of section 40 of the principal Act.
25. Settling appeals by agreement.
26. Certain appeals to lie directly to the Court of Appeal.
27. Procedural rules governing appeals.

Miscellaneous

28. Penalty for failure to comply with directions etc. of tribunal.
29. Enforcement of certain decisions of tribunal.
30. Appointments to and administration of tribunals.
31. Insolvency.
32. Refund of tax in cases of bad debts.
33. Interpretation and construction of Chapter II.

PART II

INCOME TAX, CORPORATION TAX AND CAPITAL GAINS TAX

CHAPTER I

GENERAL

34. Charge of income tax for 1985-86.
35. Rate of advance corporation tax for financial year 1985.
36. Personal reliefs.
37. Relief for interest.
38. Interest paid on deposits with banks etc.
39. Group relief: modifications.
40. Building societies.
41. Friendly societies.
42. Relief for Class 4 contributions.
43. Business entertaining expenses.
44. Business expansion scheme.
45. Profit sharing schemes.
46. Deep discount securities.
47. Partnerships: basis of assessment.
48. Limited partners: restriction of reliefs.
49. Covenanted payments to charity: increase of exemption from excess tax liability.
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* * *

[Withdrawal of right of certain non-resident companies to payment of tax credits. 1972 c.41.]

54.—(1) This section applies to a company which has, or is an associated company of a company which has, a qualifying presence in a unitary state and, at any time when it or its associated company has such a qualifying presence, is entitled by virtue of arrangements having effect under section 497(1) of the Taxes Act (relief by agreement with other countries) to a tax credit under section 86 of the Finance Act 1972 (tax credit for certain recipients of qualifying distributions) in respect of qualifying distributions made to it by companies which are resident in the United Kingdom which is equal to one half of the tax credit to which an individual resident in the United Kingdom would be entitled in respect of such distributions.

(2) Schedule 13 to this Act has effect to supplement the provisions of this section.

(3) Notwithstanding anything to the contrary in the arrangements referred to above and subject to paragraph 2 of the said Schedule, a company to which this section applies shall not be entitled to claim under subsection (4) of the said section 86 to have the tax credit referred to in subsection (1) above set against the income tax chargeable on its income for the year of assessment in which the distribution is made or, where the credit exceeds that income tax, to have the excess paid to it.

(4) A company shall be treated as having a qualifying presence in a unitary state if it is a member of a group and, in any period for which members of the group make up their accounts ending after the relevant date, 7½ per cent. or more in value of the property, payroll or sales of such members situated in, attributable to or derived from the territory outside the United Kingdom, of which that state is a province, state or other part, are situated in, attributable to or derived from that state.

(5) For the purposes of subsection (4) above—

(*a*) 7½ per cent. or more in value of such property, payroll or sales as are referred to in that subsection shall be treated as being situated in, attributable to or derived from the state there referred to, unless, on making any claim under subsection (4) of the said section 86, the claimant proves otherwise to the satisfaction of the Board, and

(*b*) the value of the property, payroll or sales of a company shall be taken to be the value as shown in its accounts for the period in question and for this purpose the value of any property consisting of an interest in another member of the group or of any sales made to another such member shall be disregarded.

(6) In this section "the relevant date" means the date on which this section comes into force or, if earlier, the earliest date on which a distribution could have been made in relation to which the provisions of this section are applied by an order made under this section.

(7) This section shall come into force on such date as the Treasury may by order made by statutory instrument appoint and the Treasury may in addition by order made by statutory instrument—

(*a*) prescribe that the provisions of this section shall apply in relation to distributions made on or after a date before that on which the order bringing them into force is made, being a date not earlier than 1st April 1985,

(*b*) prescribe those provinces, states or other parts of a territory outside the United Kingdom which are to be treated as unitary states for the purposes of this section, and

(*c*) prescribe that for subsections (4) and (5) of this section (or for those subsections as they have effect at any time) there shall be substituted either the following provisions—

"(4) A company shall be treated as having a qualifying presence in a unitary state if it is subject to tax in such a state for any period ending after the relevant date for which that state charges tax.

(5) For the purposes of subsection (4) above a company shall be regarded as subject to tax in a unitary state if it is liable there to a tax charged on its income or profits by

whatever name called and shall be treated as so charged unless it proves otherwise to the satisfaction of the Board."

or the following provisions—

"(4) A company shall be treated as having a qualifying presence in a unitary state if it has its principal place of business in such a state at any time after the relevant date.

(5) For the purposes of subsection (4) above—

(*a*) a company shall be treated as having its principal place of business in a unitary state unless it proves otherwise to the satisfaction of the Board, and

(*b*) the principal place of business of a company shall include both the place where the central management and control of the company is exercised and the place where the immediate day-to-day management of the company as a whole is exercised."

(8) No order shall be made under this section unless a draft of it has been laid before and approved by a resolution of the Commons House of Parliament.

EXHIBIT 36A
No. 176—Part II

Vol.131 WASHINGTON, WEDNESDAY, DECEMBER 18, 1985 NO. 176

Congressional Record

PROCEEDINGS AND DEBATES OF THE 99TH CONGRESS, FIRST SESSION

STATEMENT BY THE PRESIDENT

Since early in this Administration, we have been working with the states, the business community, and foreign governments in an effort to resolve issues related to state use of the worldwide unitary method of taxation. At this time I believe it appropriate for the Federal Government to state its support for the concept of legislation that would:

1. Effect a requirement that multinationals be taxed by states only on income derived from the territory of the United States ("the water's edge of requirement"); and

2. Address the question of equitable taxation of foreign source dividends.

We hoped that by this time these principles would have been enacted by the various states that have unitary taxation. Since states have not universally accepted these principles, I am instructing the Secretary of the Treasury to initiate the process of crafting Federal legislation to incorporate these principles into law and to work with the Congress for passage, and also, where appropriate, to enter into negotiations to amend double taxation agreements. I am also instructing the Secretary of the Treasury to pursue enactment of the domestic "spread-sheet" legislation, which has been previously proposed, and which is designed to assist nonunitary states with tax enforcement respecting multinational corporations in order to promote full taxpayer disclosure and accountability.

Further, I am instructing the Attorney General to ensure that the United States' interests are represented in appropriate controversies and cases consistent with this approach.

EXHIBIT 36B

UNITED STATES OF AMERICA
Congressional Record

PROCEEDINGS AND DEBATES OF THE 96TH CONGRESS
FIRST SESSION

VOLUME 125 — PART 14

JUNE 29, 1979 TO JULY 13, 1979

(PAGES 17319 TO 18652)

UNITED STATES GOVERNMENT PRINTING OFFICE,
WASHINGTON, 1979

* * *

[p. 17427] EXECUTIVE SESSION

ESTATE AND GIFT TAX TREATY WITH THE FRENCH REPUBLIC; PROTOCOL TO THE INCOME TAX CONVENTION WITH THE FRENCH REPUBLIC; THIRD PROTOCOL TO THE 1975 TAX CONVENTION WITH THE UNITED KINGDOM OF GREAT BRITAIN AND NORTHERN IRELAND, AS AMENDED; ESTATE AND GIFT TAX TREATY WITH THE UNITED KINGDOM OF GREAT BRITAIN AND NORTHERN IRELAND; TAX CONVENTION WITH THE REPUBLIC OF KOREA;

TAX CONVENTION WITH THE HUNGARIAN PEOPLE'S REPUBLIC

The PRESIDING OFFICER. The Chair is sorry to break in, but by previous order of the Senate he must do so at this time.

Under the previous order, the hour of 1:50 p.m. having arrived, the Senate will now go into executive session and proceed to the consideration of six treaties: Executive J (96th Congress, 1st session), Estate and Gift Tax Treaty with the French Republic; Executive K (96th Congress, 1st session), Protocol to the Income Tax Convention with the French Republic; Executive Q (96th Congress, 1st session), Third Protocol to the 1975 Tax Convention with the United Kingdom of Great Britain and Northern Ireland, as amended; Executive R (96th Congress, first session), Estate and Gift Tax Treaty with the United Kingdom of Great Britain and Northern Ireland; Executive P (95th Congress, 2d session), Tax Convention with the Republic of Korea; and Executive X (96th Congress, 1st session), Tax Convention with the Hungarian People's Republic. Debate thereon will be limited to a total of 10 minutes, to be equally divided and controlled by the Senator from New York (Mr. JAVITS) and the Senator from Idaho (Mr. CHURCH).

Who yields time? If no time is yielded, the time runs equally against both parties.

Mr. CHURCH. Mr. President, today the Senate has before it six tax treaties or protocols to existing tax treaties. These are: First, a protocol to the existing income tax treaty with France, second, an estate and gift tax treaty with France, third, a protocol to the pending income tax treaty with the United Kingdom, fourth, an estate and gift tax treaty with the United Kingdom, fifth, an income tax treaty with Hungary, and sixth, an income tax treaty with South Korea.

The Committee on Foreign Relations held public hearings on the proposed tax treaties and protocols on June 6, 1979. On June 12, 1979, they were considered by the committee and ordered favorably reported without reservation by a unanimous vote of the committee with a recommendation that the Senate give its advice and consent to their ratification.

The witnesses at the hearings included several experts in the area of international taxation and representatives of several organizations interested in the area as well as witnesses representing taxpayers who would be affected by the treaty. There was a general concensus that these treaties and protocols are sound, that on balance they are beneficial to the United States and its taxpayers, and that they should be approved.

The only objection to the approval of these treaties and protocols was made by the International Association of Drilling Contractors to a provision contained in the protocol to the United Kingdom income tax treaty. That provision would generally allow the United Kingdom to tax U.S. independent drilling contractors operating in its waters and would allow the United States to tax British contractors operating in U.S. waters. Following the hearings, however, the objection to the approval of the treaty was withdrawn by the U.S. drilling contractors. A telegram to that effect appears at page 58 of the committe report accompanying the United Kingdom protocol.

In view of the absence of controversy as to the approval of these treaties and protocols, I will keep my comments very brief. I would, however, like to comment on one aspect of the protocol to the pending United Kingdom income tax treaty.

The pending treaty was approved by the Senate during the last Congress with a reservation which deleted a provision which would have restricted the manner in which States of the United States could tax British multinational corporations through the application of the unitary method of apportionment. This protocol deletes that State taxation provision in conformity with the Senate's reservation. In the testimony on this protocol, those who wish to see limitations placed on the rights of the States to use the unitary method have made it clear that they support the approval of this protocol. However, they have also attempted to utilize this protocol as a vehicle to promote Federal legislation which would prohibit the States from using the unitary method.

I wish to make it clear that while I agree that this is an area that should be investigated with an open mind by the committees which would have jurisdiction, it is not a simple question. Any

limitation by the Federal Government on the taxing powers of the States raises a number of very serious issues. There is the obvious issue of federalism — the Federal Government should interfere with the States' taxing powers only with great reluctance. This is particularly true in an area such as this where there is a great deal of controversy as to whether the unitary method used by the States or the arm's-length method used by the Federal Government is the better method of apportionment of income.

In this connection, I ask unanimous consent to have printed in the RECORD a letter from the California Franchise Tax Board challenging the arguments made by those testifying in favor of Federal legislation limiting the rights of the States to tax.

There being no objection, the letter was ordered to be printed in the RECORD, as follows:

FRANCHISE TAX BOARD,
Sacramento, Calif., June 13, 1979.

In reply refer to 410:BFM:kf
HON. FRANK CHURCH,
Chairman, Senate Foreign Relations Committee, Russell Senate Office Building, Washington, D.C.

DEAR SENATOR CHURCH: Thank you for the opportunity to testify at the Committee's hearing on June 6, 1979, and for the opportunity which you extended to us to submit supplemental comments.

In reviewing the testimony offered by Senator Mathias and Marlow W. Cook, we are struck by the apparent basic misconception of the unitary method upon which their testimony is based. The unitary method does not place a tax on the worldwide income of any business enterprise. The unitary method is a means of determining the amount of income which is properly attributable to a geographic area. As stated in Section 25101, California Revenue and Taxation Code, it is a means of determining a tax "measured by the net income derived from or attributable to sources within this state." This fact has been recognized by the United States Supreme Court for over 50 years. *Bass, Ratcliffe & Gretton, Ltd.* v. *State Tax Commissioner*, [p. 17428] 266 U.S. 271 (1924). *Underwood Typewriter Company* v. *Chamberlian*,

254 U.S. 117 (1920), and is, in fact, constitutionally mandated when the corporation subjected to tax is not domiciled or incorporated in the state.

To state that "international multiple taxation is the inevitable result, if not the fundamental purpose, of the unitary tax system" is absurb.

Senator Mathias, in his statement, alleges that the opponents of Article 9(4) conceded that the question of the application of the unitary method should be legislatively addressed. This is not correct. The states objected to the use of the treaty process to circumvent full consideration by both Houses of Congress. The states, however, do not believe that a problem exists which requires federal legislation. A review of the printed record of the hearings held by Senator Mathias on what is currently Senate Bill 983 will reveal that not a single state supported the legislation proposed in the income tax area.

Mr. Cook's testimony reveals his misunderstanding of California's application of the unitary method. Under California court decisions the use of the unitary method is required, *Honolulu Oil Corp.* v. *Franchise Tax Board*, 60 Cal. 2d 417 (1963), *Superior Oil Co.* v. *Franchise Tax Board*, 60 Cal. 2d 406 (1963).

The Franchise Tax Board has no discretion in this matter. (The language authorizing separate accounting in Section 25137, California Revenue and Taxation Code, applies only where segments of a corporation are parts of different unitary businesses or give rise to nonbusiness income.) California's test of what constitutes a unitary business remains the same. Either the three-unities test. *Butler Bros.* v. *McColgan*, 17 Cal. 2d 664, 315 U.S. 501 (1941) or the contribution and dependency test, *Edison California Stores, Inc.* v. *McColgan*, 30 Cal. 2d 472 (1947) must be met. Ownership of more than 50 percent of the stock of a subsidiary is not sufficient to establish unity. In point of fact, a court in San Francisco has recently ruled that a 51.5 percent owned subsidiary was not unitary even though the other unitary elements were satisfied. *ASARCO* v. *Franchise Tax Board*, San Francisco Superior Court Docket No. 712-405.

Mr. Cook also states that the states are seeking to tax income which the Internal Revenue Service has decided is foreign source income under section 482 of the Internal Revenue Code. As pointed out previously, the unitary method does not tax such income. But more importantly, the Internal Revenue Service has not classified such income as foreign source income under Section 482. The taxpayer has so classified the income, and the Internal Revenue Service, in order to attach such characterization, must rely on Section 482; but this is a far different state of facts than Mr. Cook's assertion that "the Secretary of Treasury has determined, for federal income tax purposes, income property should be allocated under Section 482 of the Internal Revenue Code to foreign operations . . ." Finally, Mr. Cook should examine the summary and explanation of President Carter's 1978 Tax Program where the Treasury specifically criticizes ineffectiveness of Section 482. (Pages 282-297)

Finally, Mr. Cook refers to the United States Supreme Court's recent decision in *Japan Lines, Ltd.* v. *County of Los Angeles*, (April 30, 1979). Even a cursory reading of the opinion makes it obvious the Court was addressing a very limited question involving *ad valorem* property taxes and specifically so limited its decision. Of particular note was the Court's failure to even discuss, let alone overrule *Bass, Ratcliffe & Gretton, Ltd., supra*, a decision dealing directly with the imposition of a state income tax on a foreign country corporation, utilizing a formula method to determine the measure of the tax. The Court has clearly not ruled the unitary method inapplicable to foreign corporations. If, in fact, the Court should so rule, then the need for Article 9(4) and Senate Bill 983 would be obviated.

In conclusion, we urge that the Senate Foreign Relations Committee approve the United States — United Kingdom Tax Convention and the Protocols attached thereto without any reservation or recommendation on Senate Bill 983.

Very truly yours,
BRUCE W. WALKERS,
Chief Counsel.

Mr. CHURCH. In conclusion, these tax treaties and protocols will be of substantial benefit to U.S. taxpayers doing business or living in the countries involved. The proposed treaties and protocols with the United Kingdom and France represent important modernizations in our treaties with those countries and reflect changes in the domestic laws of the countries involved since the treaties were last negotiated. For example, under the pending United Kingdom Income Tax Treaty which is contingent upon approval proposed United Kingdom protocol. U.S. investors in United Kingdom corporations will receive British tax refunds at a rate of approximately $100 million a year. The proposed French protocol would alleviate double taxation of U.S. citizens resident in France which would otherwise result from recent changes in French jurisdictional tax rules. The proposed treaties with Korea and Hungary represent important expansions of our treaty programs with developing countries and countries of eastern Europe.

Mr. President, these treaties are significant steps in reducing non-tariff barriers to trade and in alleviating double taxation. I urge that the Senate give its advice and consent to their ratification.

The PRESIDING OFFICER. The time of the Senator from Idaho has expired. The Senator from New York has 4 minutes.

Mr. JAVITS. Mr. President, I rise in support of the six tax treaties with the United Kingdom, France, South Korea, and Hungary that are before us today. The Foreign Relations Committee has held hearings on all the treaties and has ordered them favorably reported by a vote of 13 to 0, with the recommendation that the Senate give its advice and consent to ratification of each of the Treaties.

While each treaty is significant with respect to the regularization of tax relations between the United States and the particular county, it is the United States-United Kingdom Tax Treaty that has received special attention for well over 2 years. While I advocated last year ratifying that tax treaty without reservation, I am, nevertheless, pleased that today we will be acting favorably on the amended text.

The problem caused by the continued ability of the states to use worldwide combination under the unitary tax system remains, however. It is imperative that an equitable solution be found since our companies operating overseas may one day find themselves subject to such worldwide combination by political subdivisions of other countries. It will be very difficult for the U.S. Treasury to defend the interests of our corporations against such taxation practices in information tax treaty negotiations until we have resolved the issue in the United States. I call the attention of my colleagues to the fact that, in its report on the United States-United Kingdom Tax Treaty, the Foreign Relations Committee urged the tax writing Committees of the Congress — the Finance Ways and Means Committees — to hold hearings on S. 983, the interstate taxation bill introduced by Senator MATHIAS, which would accomplish legislatively for all nations what article 9(4) of the United States-United Kingdom Tax Treaty sought to accomplish for the United Kingdom. Resolution of this issue is critical for the maintenance of a favorable climate for foreign investment in the United States, and the Congress should have the opportunity to take a position on the merits of the issue.

While the issues raised by article 9(4) will continue to be important and must be resolved, we have before us a balanced tax treaty, which provides substantial benefits to both the United States and the United Kingdom. Once ratified here, I hope that the Parliament will consider expeditiously the treaty so that these benefits can begin to accrue to each side.

Both the number of tax treaties we have before us today and of those that are in the various stages of negotiation underline the new-found importance of these treaties in resolving the conflicts that result from different national taxation systems. The existence of such treaties facilitates the free flow of capital among countries and, hence, is an important element in the growing interdependence of the various national economies.

To assist the Senate with its constitutional duties, I shall ask the chairman of the Foreign Relations Committee to have the committee undertake a thorough study of our tax treaty program. Such an in-depth analysis, which would include hearings with expert witnesses from the administration and private sector, could

focus on the emerging requirements for tax treaties resulting from these conflicts in national taxation systems and whether the procedures followed by the Treasury for both public and congressional involvement in the tax treaty making process are adequate and whether and how they could be improved. I look forward to working very closely with the distinguished chairman of the Foreign Relations Committee as well as with the international tax experts of the Joint Committee on Taxation in this endeavor.

Mr. WALLOP. Mr. President, the United States-United Kingdom Tax Treaty has been the subject to considerably controversy, particularly its attempted limitation on the States in taxing foreign source income. When the Senate considered the treaty last June, article 9(4) was essentially removed by reservation. During Senate consideration at that time, some Senators argued that the appropriate forum for discussions [p. 17429] of limitations on the States should involve both Houses of Congress.

In the March 8, 1977 House Ways and Means Committee report dealing with State taxation of foreign source income, several pertinent questions were addressed. I ask unanimous consent that part IV of the report (pages 25-30) be printed in the RECORD following my remarks.

The PRESIDING OFFICER. Without objection, it is so ordered.

(See exhibit 1.)

Mr. WALLOP. I also would like to point out that Senator MATHIAS has introduced legislation, S. 983, which addresses the problem of States' rights to use the worldwide combined reporting system. Because of the controversy and complexity of the issue, I hope that Congress will have an opportunity to fully examine this question.

EXHIBIT 1

IV. STATE TAXATION OF FOREIGN SOURCE INCOME

Present law and background

General structure of State taxation of corporations. — The question of State taxation of foreign source income is one aspect

of the larger question of State taxation of businesses operating in more than one State. This larger question involves the problem of determining a State's jurisdiction for taxing a corporation's income and uniform rules for apportioning and allocating that income among the States in which a corporation does business. Of the 45 States which impose a corporate income tax, all use some kind of formula to apportion business income between the various States in which a corporation operates. However, the specific formula used varies substantially from State to State.

In determining income earned within a State, most States (30 out of 45) use some variation of a basic three-factor apportionment formula. Under this formula the income of a corporation is apportioned to each State according to the average ratio of three factors: the sales, payroll, and property values of the corporation. For example, a corporation which has one-half of the value of its property, three-fourths of its payroll, and one-fourth of its sales in a particular State would take the average of these three fractions (one one-half) to determine the amount of income subject to tax in that State.[1]

A State's apportionment formula is usually applied only to income of a corporation where the business activity from within the State is dependent upon, or contributes to, business activities of the same corporation outside of the State. Ordinarily, in a case where the business activity in the State is unrelated to other businesses of the corporation outside of the State, all of the income from that business within that State is allocated to that State (and the income from the other businesses is not allocated to the State).

[1]The 15 States which do not follow this three-factor formula use other apportionment formulas, some based on property values only and others based on a combination of sales and property or sales and payroll or property and payroll. Even among those States which do use the basic three-factor formula, the manner of measuring the three items in the formula may differ. For example, in some States a sale is taken into account by the State where the sale originated (generally, the location of the seller) while in other States the sale is allocated to the State of destination (generally where the buyer is located).

Some States, primarily California and Oregon, have adopted what is known as the "unitary method" of applying the three-factor apportionment formula. Under this method the formula is applied not only to the income of the specific corporation operating in the State but also to any income of related corporations (subsidiaries, parent corporations, or brother-sister corporations) where the related corporations' activities outside of the State are dependent upon or contribute to the business of the corporation within the taxing State.

In many States, not all of the income of a corporation is subject to that State's apportionment formula. For example, in many States passive income such as dividend income is allocated entirely to the State of the "commercial domicile" (or in some cases the State of the "principal business location") of the corporation and is thus excluded from the income subject to the apportionment formula.

Taxation by States of foreign source income. — Virtually all States include the income of foreign branches of domestic corporations in the income which is subject to their apportionment formula. For example, if a corporation had two-thirds of its sales abroad, but the other one-third of its sales, one-half of its property, and two-thirds of its payroll in one State, the corporation would be taxed on one-half of its income by that State.

In those States which have adopted the unitary method and thus apply their apportionment formula to income of a related group of corporations, the income of foreign affiliates of U.S. corporations is subject to apportionment if the activities of the foreign affiliates are dependent upon or contribute to the business of the corporation within the taxing State. These States thus treat income of foreign corporations related to U.S. corporations in the same manner as most States treat income of foreign branches of U.S. corporations.

Dividends of a foreign subsidiary are sometimes subject to State tax when received by a domestic corporation. In these cases the dividends are taxed in the same manner as dividends from domestic corporations (i.e., taxed by the State where the corporation is commercially domiciled or has its principal place of

business, added to the income subject to the apportionment formula of the taxing State, or, in some cases, taxed in both States). However, many States do not significantly tax any dividends from related corporations.

Previous attempts to modify present law. — As a result of court decisions in the late 1950s and early 1960s which expanded the constitutional limits of a State's jurisdiction to tax corporations with minimal levels of economic activity within the boundaries of that State, Federal legislation was enacted which required that a corporation at least accept and approve sales orders within any State before that corporation can be subjected to the income tax of that State. In more recent years, legislation mandating greater uniformity in the rules for State taxation of corporations has been introduced and studied. One such bill, which was reported by the House Judiciary Committee, passed the House in 1969 but was not enacted.

In 1969, a group of States reacted to the possibility of Federal legislation by adopting a multi-state tax compact, which established the Multistate Tax Commission whose duties are to establish uniform income tax regulations, auditing standards and tax forms for member States. Presently, 20 States are members of the compact (the majority of the States are Midwestern and Western States). Under the compact, the regulations of the Multistate Commission are effective in all member States, but any member State can adopt overriding regulations if they choose. Since most of these States have adopted some overriding regulations, the methods of taxing corporations still vary substantially among States which are members of the compact.

Issues

Although a larger controversy exists over the States' jurisdiction to tax income and the need for uniform rules among the States, the basic issue before the task force was whether the Federal Government should prohibit States (a) from taxing foreign source income directly, or (b) from taking into account foreign source income under the unitary method (as described above).

Alternatives

Limitations in applying the unitary method of apportionment. — States could be prohibited from requiring the reporting of income and related items of foreign corporations even though related to U.S. corporations which operate within that State. Under this proposal, the unitary method would not be applied either to foreign subsidiaries of U.S. corporations, to foreign parents of U.S. subsidiaries, or to other affiliated foreign corporations. This would not, however, prevent a State from taxing dividends paid by foreign subsidiaries, interest, or royalties received from foreign affiliates or other foreign sources, nor would it prevent the application of the three-factor formula to branch income from foreign operations of U.S. corporations operating in the State.

The reporting of income and related items of foreign corporations could be limited to activities of U.S. corporations which relate to exports from or imports to the United States, but the treatment of dividends, etc., could remain the same as above for income from other corporations.

The reporting of income and related items could be barred in the case of foreign-owned corporations with affiliates operating in any State, but allowed with respect to foreign subsidiaries of U.S.-owned corporations operating within the State (as would be done with U.K.-owned companies in the proposed convention between the United States and the United Kingdom). Dividends, etc., could remain taxable as above. Under this proposal, in the case of foreign-owned affiliated group of corporations, any State would be limited to applying its apportionment formula to the income of any member of the affiliated group operating within that State or other States.

Limitations on direct taxation of foreign source income. — States could be prohibited from directly taxing in any way foreign source income. This means they not only would not tax income through the unitary method, but also would not tax dividends from foreign subsidiaries, foreign source interest or royalties, or branch earnings of U.S. corporations. The States could also be prohibited from taxing foreign income of individuals.

States could be prohibited from taxing through the unitary method foreign affiliates not doing business in the State or from taxing dividends from foreign affiliates of U.S. companies, but allowed to tax interest or royalties or branch income.

Analysis

Limitations on the unitary method of apportionment. — For Federal income tax purposes, an apportionment formula is not used to divide income and costs between United States and foreign countries. Instead, income and costs are allocated between related companies using the criterion of what the costs and prices would be between these parties if they were independent parties dealing at arm's length (sec. 482). On the other hand, in computing what portion of the income of a single company is from foreign sources, an allocation of income and deductions approach is used (sec. 861). This approach already [p. 17430] produces significant problems when applied at the Federal level and would be virtually impossible to administer at the State level as applied to interstate transactions. Thus, there is no significant disagreement that the States must use some type of apportionment formula (as distinguished from making an allocation of income and deductions by separate accounting), since there would be no practical way of determining what income of a company is earned within a State as opposed to being earned within other States (or in foreign countries).

The rationale presented for using the unitary method to combine the business activities of related corporations which contribute to the business activities of a corporation within a taxing State is that the operations form an integrated business, and whether the business is conducted through a number of separate corporations or through one single corporation should not affect tax liability.

It is disputed whether those States applying the unitary method of taxing corporate business income under an apportionment formula do, in fact, tax the income of related foreign corporations. For example, under the three-factor apportionment formula, if it takes the same dollar amount of sales, the same value of property

and the same sized payroll to achieve a given level of income in the foreign subsidiary as it takes in U.S. operations, then no foreign income would be taxed by any State because the three factors would apportion the appropriate amount of income to foreign countries and to the State.

However, it is argued that in many countries abroad wages and property values are lower in proportion to income than in the United States. It is argued that, given these circumstances, the inclusion of foreign corporations under the unitary method of apportionment leads indirectly to State taxation of foreign source income by apportioning too much income to the United States. Whether or not this actually is the result in any specific case depends on whether the proportion of income to wages, property costs and sales in the specific country in which a corporation operates is higher than the proportion of the same items in the United States. In some cases, the unitary method operates to apportion more income to the United States than most people would agree should be so apportioned if each affiliate were treated as an independent entity operating on an arm's-length basis. However, in other cases the application of the unitary method may apportion less income to a State than would be apportioned under other acceptable methods.

An additional problem raised in relation to those States which have adopted the unitary method is the administrative burden which that method places on corporate taxpayers, particularly those which are foreign owned. For example, a corporation with one manufacturing plant in a unitary State has to obtain for that State's tax purposes the income, sales, property and payroll figures of all of its affiliates operating worldwide if the activities of those affiliates are dependent upon or contribute to the activities of the corporation within that State. In the case of a foreign parent corporation, this compliance burden could be particularly costly because a foreign-owned foreign corporation ordinarily would not otherwise keep the books of its operations outside of the United States in terms of U.S. dollars or in a manner which would conform to U.S. accounting concepts.

The need for applying the unitary method may not be as great when taking into account foreign source income than when taking

into account income from a number of States. The number of transactions in any State linked to foreign operations is ordinarily substantially fewer than the number of transactions linked to different States. Moreover, since taxpayers are in any event required to allocate income between U.S. and foreign sources for Federal income tax purposes, the States could adopt the Federal rules for apportioning income from foreign transactions between domestic and foreign sources.

Some critics of the unitary method of apportionment would nevertheless permit its use where the States can show that there is less than arm's length pricing in foreign transactions. If the unitary method were allowed only in this case, the State affected to the most substantial extent would be California. California State tax officials estimate that such a limitation would cost that State approximately $125 million in revenue, or about 12 percent of total corporate tax revenues.

It has also been suggested that the application of the unitary method could be limited to those cases where the business activities of the foreign subsidiary are related to exports from or imports into the United States. Export-related transactions generate the most difficult income allocation questions under the Federal tax rules, and thus it is suggested that it is appropriate to allow the States to decide whether Federal rules should be followed in those circumstances.

If the administrative burden which the unitary method causes taxpayers is viewed as the primary problem, the application of the unitary method to foreign corporations owned by foreigners could be prohibited.

Limitations on directly taxing dividends from foreign subsidaries —

Except as that result may be achieved indirectly under the unitary system, no State taxes the income of foreign subsidiaries (not doing business with the State) of U.S. corporations as that income is earned; that income is taxed only when it is remitted to a U.S. corporation as a dividend. In those States which tax foreign source dividends, it is argued that double taxation results because no credit is allowed for foreign taxes paid.

The Federal Government taxes dividends from foreign subsidiaries of U.S. corporations when they are brought back to the United States, but allows a foreign tax credit for foreign (national, state and local) income taxes paid by the subsidiary. Thus, to the extent that foreign income taxes do not exceed 48 percent of foreign taxable income, the tax burden on foreign source income also taxed by a State is no greater than the tax burden on domestic source income which is taxed by the Federal Government at 48 percent and by the State as well.

As in the case of State taxation of dividends from domestic corporations, the lack of uniform rules among the States does lead to over-taxation or under-taxation in various cases. If the taxation of dividends of foreign subsidiaries is prohibited, domestic source income in some cases will be taxed more heavily than foreign source income because all income taxes paid to local governments in foreign countries, as well as the income taxes paid their national governments, are creditable against U.S. Federal tax while income taxes paid to U.S., State and local governments are only deductible, and not creditable for Federal purposes.

Recommendations

The task force makes the following recommendations with respect to State taxation of foreign source income:

(1) *Income of foreign affiliates not subject to Federal income tax.* — It is recommended that the States be precluded from taking into account, under the unitary method or any other method, the income of foreign affiliates of corporations doing business within the States until such time as that income is subject to Federal income tax.

(2) *Income of foreign affiliates subject to Federal income tax.* — It is further recommended that no limitation be placed on the power of the States to apply the three-factor formula on a domestic basis, under the unitary method or otherwise, to income of foreign affiliates which had been excluded under paragraph (1) above if and when such income becomes subject to Federal income tax.

Mr. JAVITS. I yield 1 minute to the Senator from Alaska.

The PRESIDING OFFICER. The hour of 2 o'clock having arrived, the Senate will not proceed —

Mr. JAVITS. Mr. President, I ask unanimous consent that I may yield 1 minute to the Senator from Alaska.

The PRESIDING OFFICER. Without objection, it is so ordered. The Chair recognizes the Senator from Alaska.

Mr. STEVENS. Mr. President, last year when the United States-Korean Tax Treaty was pending on the calendar, several Senators expressed their concerns about article 10. This provision raised substantial issues regarding incentives which encourage the construction and operation of foreign-flag vessels and the provision's implication regarding traditional U.S. treaty response to this issue. The Secretary of the Treasury assuaged the Senators' concerns and expressed the Department's endorsement of a strong U.S. merchant marine fleet.

While the Secretary's response addressed the immediate concerns raised by this particular treaty, further questions remain unanswered. I find it disturbing that certain tax code provisions encourage flag of convenience shipping; possibly at the expense of the American maritime industry and the U.S. Treasury. Following are five sets of questions relating to these tax incentives which I would like the Treasury Department to investigate. Responsible congressional action in this area requires the availability of information on existing code provisions and their demonstrated effect on foreign-flag vessels. Attention to these questions will do much to aid Congress in its pursuit of tax provisions which are in the best national interest.

First, what U.S. tax mode provisions currently exist which encourage American shippers to register in a foreign country? How do these incentives change the proportion of U.S. owned and registered ships to flag of convenience vessels? What revenue effect is the result of this change?

Second. To what extent do these tax provisions affect the number of vessels built in U.S. shipyards? Assuming a reduction in American vessels built, what repercussions are there for employment, both in the shipbuilding industry and related industries,

such as steel? Do these losses represent a substantial reduction in revenues to the U.S. Treasury?

Third. Foreign flag shippers need not comply with U.S. laws and are therefore not required to abide by our labor laws nor our environmental safety standards. To what extent does this fact discourage the hiring of American labor and subsequently affect transfer payments from the U.S. Treasury: Does the escapement from U.S. environmental safety standards endanger our marine and coastal environments thus posing potential economic loss for both shipping concerns and the U.S. Treasury?

Fourth. Given that the flag of convenience vessels must abide by the shipping [p. 17431] requirements for the country in which the vessels are registered, to what extent are trade routes impacted? Is there an impact on the quantity or variety of goods shipped to or from the United States? Is there a revenue loss as a result?

Fifth. Does the use of foreign flag vessels influence our balance of payments?

It is my belief that encouragement of foreign flag vessels may be detrimental to the maintenance of a strong merchant fleet and may undermine efforts to deal with unemployment, environmental safety, and the trade deficit. A thorough study of the composite effects of this encouragement will be invaluable to Congress as we pursue legislation which is in our best national interest. I urge the committee to join with me in requesting answers to these questions.

United States-United Kingdom Tax Treaty

Mr. MORGAN. Mr. President, last summer, during the initial consideration of the United States-United Kingdom Tax Treaty, I advised my colleagues after the inclusion of the Church reservation, that by voting for that reservation they had placed themselves at the mercy of the British Parliament not to reconsider their own tax concessions to us and that we were thus relying on their good will which we were not willing to show ourselves. I forecast that this issue is far from closed and expressed that I had no doubt that this body will again be asked to deliberate a new tax

treaty with the United Kingdom, one which will unfortunately be less favorable than the version which was originally before us last summer.

Evidently, there is considerable concern among the members of the British Parliament concerning the use of the worldwide combined reporting system of taxation assessment.

I would ask unanimous consent that a copy of the Early Day Motion filed in the House of Commons on June 11, 1979, indicating the support of 59 members of the House of Commons, be printed in the RECORD in connection with the treaty. I understand that now more than 100 members of the House of Commons have expressed their support of that motion.

There being no objection, the motion was ordered to be printed in the RECORD, as follows:

DOUBLE TAXATION RELIEF TREATY BETWEEN THE UNITED STATES OF AMERICA AND THE UNITED KINGDOM

Mr. Geoffrey Rippon, Mr. William Clark, Mr. Peter Hordern, Mr. Michael Grylls, Mr. Roger Moate, Mr. Patrick McNair-Wilson, Mr. Peter Emery, Mr. Bentley Heddle, Mr. John Hunt, Mr. Mark Wolfson, Sir Anthony Meyer, Mr. Peter Rost, Mr. Robert Dunn, Mr. John Corrie.

Mr. Michael Ancram, Mr. Graham Bright, Mr. Eldon Griffiths, Mr. Christopher Murphy, Mr. John Stokes, Sir Nigel Fisher, Mr. Geoffrey Dodsworth, Mr. Charles Irving, Mr. Nicholas Winterton, Mr. Tom Normanton, Mr. Ian Grist.

Mr. Robert Rhodes James, Sir John Langford-Holt, Mr. David Price, Mr. Tim Rathbone, Mr. John Hannam, Mr. Hal Miller, Mr. Walter Clegg, Mr. Michael Shaw, Mr. A. P. Costain, Mr. Victor Goodhew, Mr. Malcolm Thornton, Mr. Michael Mates, Mr. John Loveridge, Mr. Jim Spicer, Mr. Michael Brown, Mr. Timothy Eggar, Mr. Ralph Howell.

Mr. Robert McCrindle, Mr. Sydney Chapman, Mr. John Selwyn Gummer, Mr. Keith Wickenden, Mr. Ivan Lawrence, Mrs. E. Kellett-Bowman, Mr. Keith Proctor, Mr. Michael Colvin,

Mr. R. Graham Page, Mr. John Ward, Mr. Richard Body, Mr. Barry Henderson, Mr. Ivor Stanbrook, Mr. Robert Atkins, Mr. John Spence, ★59, Mr. Alastair Goodlad, Mr. Charles Fletcher-Cooke.

That this House is of view that a vital feature of any relationship between the United States of America and the United Kingdom regarding relief from double taxation should be a clear understanding prohibiting the use of the worldwide combined reporting system in assessing the tax of corporations doing business in both countries, such as would have been accomplished by Article 9(4) of the original Double Taxation Relief Treaty between the United States of America and the United Kingdom; and urges Her Majesty's Government to do its utmost to ensure that any contrary arrangement be rectified so as to avoid a harmful international precedent and serious consequences for both British and United States companies with overseas interests.

Mr. MORGAN. Mr. President, it will note that they feel that a vital feature of any relationship between the United States of America and the United Kingdom regarding relief from double taxation should be a clear understanding prohibiting the use of the worldwide combined reporting system in assessing the tax of corporations doing business in both countries.

Ultimately, I would prefer to have the tax issue raised in a bill rather than a treaty so that both Houses would have an opportunity to discuss the fiscal implications of this issue. I understand that Senator MATHIAS has introduced S. 983, section 303 of which would seek to eliminate double taxation by prohibiting the use of a worldwide combined reporting system. It appears essential to the adoption of the treaty by Parliament that this bill receive a complete review. Until that occurs it still appears that this issue is far from closed.

★The figure following this symbol gives the total number of names of Members appended, including those names added in this edition of the Notices of Questions and Motions.

UNITED STATES-UNITED KINGDOM INCOME TAX TREATY

● Mr. PELL. Mr. President, it is with great satisfaction that I support the third protocol to the Income Tax Treaty between the United States and the United Kingdom. Even before the treaty itself was submitted to the Senate last year, I was active in support of the effort embodied in the second protocol to this treaty to correct a serios inequity affecting U.S. citizen women married to U.K. subjects residing in Britain. I have, therefore, a very direct and personal interest in this treaty.

Last year, I was the majority floor manager for this treaty, which received the advice and consent of the Senate subject to a reservation which had the effect of nullifying article 9(4). This article would have restricted the power of individual States to apply the "unitary method" of taxation of U.K. companies. I am pleased that the British Government agreed to renegotiate this provision in the form of the third protocol, as an up-to-date agreement on income taxes is important to individuals and corporations of both countries.

In last year's debate on article 9(4), a major argument advanced by the opponents of this article was that States employing the "unitary method" of taxation should not be forced to abandon that system of taxation with respect to United Kingdom corporations through a treaty. Instead, it was argued, the limited change provided for in article 9(4) should be addressed through legislation involving the House as well as the Senate. Thus, the senior Senator from Idaho, who sponsored the reservation on article 9(4), said at the time the Senate was considering the treaty that "article 9(4) could serve as a precedent for fashioning internal tax policy via agreements with foreign governments. As such, a new method will have been devised for obtaining legislation through the treaty process, circumventing the tax-writing committees of both the House and the Senate."

I am confident that the Senate will give its advice and consent to the third protocol that is before us today. I hope, therefore, that with the approval of this protocol, early consideration will take place of the kind of legislation on taxation methods that Senator CHURCH and other opponents of article 9(4) spoke of last year.

One such legislative approach is S. 983, sponsored by Senator MATHIAS. Other approaches may also be developed, but the important thing in my view is that with the approval of the third protocol, the Senate should take a close look at the "unitary method" of taxation as it relates to foreign corporations.●

UNITED STATES-UNITED KINGDOM TAX TREATY

● Mr. HUDDLESTON. Mr. President, earlier this month I had the opportunity to meet Michael Grylls, Member of the House of Commons. Mr. Grylls was in Washington to attend the hearing on the United States-United Kingdom tax treaty before the Senate Foreign Relations Committee. During our conversation Mr. Grylls made it plain to me that the British consider an ultimate resolution to the problem posed by the use by certain States of the worldwide combined reporting system method of tax assessment essential to any relationship regarding double taxation between the United Kingdom and the United States. He advised me that an early day motion had been filed in the House of Commons which clearly made that point.

I submit for the RECORD a copy of the statement of Michael Grylls, Member of the House of Commons, which was included in the testimony of Senateor MATHIAS before the Senate Foreign Relations Committee on June 6, 1979, concerning the United States-United Kingdom tax treaty. A copy of the early day motion is included in that statement.

The material follows:

STATEMENT OF MICHAEL GRYLLS MP, REGARDING THE DOUBLE TAXATION RELIEF TREATY BETWEEN THE UNITED STATES AND THE UNITED KINGDOM

I have been a Member of the House of Commons since 1970. As I was involved in private business prior to my first election I have been vitally interested in the relation of government and industry, both nationally and internationally. I am a member of the Conservative Commonwealth Council, a Fellow of [p. 17432] the Royal Institute of International Affairs, and have served as Vice-Chairman of the Conservative Industry Committee.

Thus, I followed the discussions in Parliament regarding this Treaty between the United States and the United Kingdom quite closely, with particular attention to the treatment in the Treaty of the use of the worldwide combined reporting systems in assessing the taxation of companies doing business in both countries, even elsewhere. When the House of Commons considered the Treaty on January 12, 1977, it was pointed out that no complaint was being made in England about reducing barriers to international investment and that the consequences of the Treaty, especially regarding remittances, looked far more favourable to the United States and its Internal Revenue Service, than to the United Kingdom.

Article 9(4) of the Treaty was considered to be an essential part. Its importance was due to the fact that it would put right the plainly wrong situation wherein certain states in the United States could impose taxes on companies not by virtue of their operation in a single state alone, but by the size of their operations throughout the world.

When we considered the Treaty we did so without the benefit of knowing how the United States Senate would treat the Treaty. That body subsequently removed Article 9(4). A third Protocol to that effect has resulted and is now before the United States Senate for ratification. Of course, if approved by the Senate, approval must also be obtained from Parliament.

There is substantial evidence that the absence of an Article 9(4) type prohibition in the Treaty will cause it to be subject to very close scrutiny and enlarged debate as we consider it in the House of Commons. The confederation of British industry, which is the leading representative body of British industry, both public and private, has recently written to the Chancellor of the Exchequer, Sir Geoffrey Howe, suggesting that the Treaty should not be adopted in its present form. The confederation pointed out to the Chancellor that the "combined reporting unitary system" of taxation leads to multiple taxation and in fact has been condemned by the Organization for Economic Co-operation and Development of which both the United States and the United Kingdom are members. I understand that the United States Supreme Court has in a recent decision also condemned taxation

by states upon instruments of foreign commerce when it results in double taxation or prevents the United States from speaking in one voice regarding such international activities.

The Chairman of the Bowater Corporation Limited, The Rt Hon Lord Erroll of Hale, in his statement contained in its 1978 Annual Report and Accounts, said that such taxation systems "if widely adopted, could cause groups of companies which operate internationally to suffer multiple taxation on their profits. This would clearly be both unjust and inimical to the proper flow of international investment".

A resolution has been placed before the International Chamber of Commerce which makes clear the need for one voice in matters on international taxation by political subdivisions and urges all possible measures be taken to ensure that the terms of an agreement or treaty dealing with taxation on income shall bind all authorities having jurisdiction within the boundaries of each contracting state.

Attached to this statement is a copy of an Early Day Motion which will be introduced in the House when it returns from recess on June 11, 1979. That motion reveals that prohibition of the use of the worldwide combined reporting systems of taxation assesment is essential to any United States-United Kingdom relationship regarding multiple taxation. Personally, I have been amazed at the short-sighted view taken by the Third Protocol and have marveled that my country and the United States which together have the largest numbers of multinational corporations in the world, and thus the most to lose from setting such a precedent, would negotiate such an open ended arrangement making available this practice of multiple taxation to other countries and their political subdivisions.

I have reviewed the hearings of the Senate Foreign Relations Committee regarding the Treaty and read the pages of the Congressional Record containing the debate concerning its ratification. I noticed an admission among those who expressed opposition to Article 9(4) that there was a problem caused by the unrestrained use of the worldwide combined reporting system and

that the proper avenue towards a solution was one of legislation which would be considered by both Houses of Congress.

I am aware that legislation has been introduced in the United States Senate sections of which address this problem. From my understanding of the recent United States Supreme Court decision it appears that if the Treaty does not deal with this problem, and the United States Congress otherwise fails to address it, then aggrieved companies will certainly be in a position to resort to the United States courts for relief though costly and time consuming.

British industry and Parliament shall be following with great interest the discussions of the Treaty by the Senate Foreign Relations Committee and the full Senate. Indications and assurance that the problems caused both the United States and the United Kingdom by the use of the worldwide combined reporting system are being rectified either in the Treaty or by legislation which will be passed by the United States Congress will be quite helpful in obtaining approval of any treaty submitted to Parliament for approval.

HOUSE OF COMMONS,
London SWIA OAA.

EARLY DAY MOTION TO BE SUBMITTED TO THE HOUSE OF COMMONS ON 11TH JUNE 1979

That this House is of the view that a vital feature of any relationship between the United States of America and the United Kingdom regarding relief from double taxation should be a clear understanding prohibiting the use of the worldwide combined reporting system in assessing the tax of corporations doing business in both countries, such as would have been accomplished by Article 9(4) of the original Double Taxation Relief Treaty between the United States and the United Kingdom: and this House urges Her Majesty's Government to ensure that arrangements be made to rectify a harmful international precedent and serious consequences for both British and United States companies with overseas interests.●

● Mr. MATHIAS. Mr. President, I would like to make a few comments about the article 9(4) issue in the United Kingdom tax treaty, not to urge that the treaty be altered again, but rather to urge support for my effort to address the problem legislatively. I have introduced S. 983, the interstate taxation bill, and that bill, in section 303, would accomplish for all nations what our negotiators attempted to achieve in article 9(4) for the United Kingdom alone.

The legislative approach not only will resolve the problem across the board rather than on a treaty-by-treaty basis, but it will also answer the requests of those House Members who, during the Senate debate on the treaty, spoke with me about the possibility of substituting the bill for article 9(4), because a legislative approach would give them an opportunity to address the issues raised by the article.

Since the introduction of the bill, several events have taken place which should give increased impetus to such a legislative solution. The Supreme Court of the United States in the recent *Japan Line, Ltd.* v. *County of Los Angeles* case No. 77-1378, decided April 30, 1979, seems to be moving in the direction of ruling that the use of worldwide combined reporting system of taxation violates the commerce clause of the Constitution.

As indicated in the statement of Michael Grylls, Member of the House of Commons of Great Britain, which was included in my testimony before the Senate Foreign Relations Committee regarding the treaty, Parliament will not accept the treaty as it is now drafted unless it receives assurances that a legislative resolution of the problem is imminent. In fact, the Confederation of British Industry, which is the equivalent of the U.S. Chamber of Commerce, has recommended that the treaty be renegotiated if the legislation fails of passage. Also, an early day motion has been filed in Parliament and has, at last count, 100 supporters. That motion would express the sense of the House of Commons that the worldwide combined reporting system should be eliminated.

Of course, this problem concerns other countries and their relations with the United States and U.S. corporations. The United States must speak with one voice in its foreign relations,

and the Constitution requires that the Federal Government provide that voice. There is also the possibility that, if the United States continues to allow more than one voice in taxation of international enterprise, other countries and their political subdivisions will follow suit.

I would like to quote from page 6 of the report of the Committee on Foreign Relations on the third protocol to this treaty, June 15, 1979:

The [Foreign Relations] Committee urges the tax-writing committees of the Congress — the Finance and the Ways and Means Committees — to hold hearings in the very near future on S. 983 in order to permit all sides of the issue to have their views known for the record. In addition, such legislation will give the Congress, which has the responsibility to resolve on the federal level inconsistent state taxation policies, the opportunity to take a position on the merits of the issue.

Keeping these considerations in mind, I look forward to complete and adequate hearings on S. 983 in September so that we can move forward in solving this serious problem and furnish the British Parliament with sincere assurances that we understand and appreciate the gravity of the situation and are striving toward a solution.●

● Mr. GLENN. Mr. President, I supported the United States-United Kingdom tax treaty when it was considered by the Senate in June of 1978. During the consideration of that treaty in the Foreign Relations Committee, I also favored its approval without a reservation to article 9(4), a provision which would [p. 17433] have restricted the ability of a State to use the worldwide combined reporting system in assessing the State income tax liability of a United Kingdom corporation. That article, of course, was removed from the treaty by such a reservation.

The controversial feature of the worldwide combined reporting system is its extraterritoriality. The apportionment calculation under this unitary method of taxation is applied, not simply to the corporation which is doing business within the State, but also to affiliated corporations which may not be doing any business in the State, or in the United States for that matter. This extension of

State taxing power through the unitary method to foreign corporations not doing business in the State, or perhaps in the United States, could subject them to double taxation. That causes concern.

Since the Senate considered this matter in June of 1978, there have been developments of which we should be cognizant. A recent decision of the U.S. Supreme Court in the case of *Japan Line, Ltd.* v. *County of Los Angeles*, No. 77-1378, which was decided on April 30, 1979, has established that when a State seeks to tax the instrumentalities of foreign, rather than interstate, commerce, a court must first inquire whether the tax creates a substantial risk of international multiple taxation, regardless of apportionment. Second, that decision holds that the Court must inquire whether the tax prevents the Federal Government from "speaking with one voice when regulating commercial relations with foreign governments."

More recently, the Supreme Court has decided to hear an appeal brought by Mobil Oil Corp. from a decision of the supreme court of Vermont that deals with the issue of whether it is constitutional for a State to tax dividends from foreign subsidiaries and investments received by corporations that are not based in the State.

Also, Senator MATHIAS has introduced a bill, S. 983, which provides in its section 303 for a prohibition against the use of the worldwide combined reporting system by States in assessing the tax of corporations doing business in more than one country. I feel that the Senate should give its fullest consideration to this issue, given the recent history of Supreme Court actions.●

UNITED STATES-UNITED KINGDOM TAX TREATY

Mr. PERCY. Mr. President, the Senate is today voting on the third protocol to the United States-United Kingdom tax treaty. When the treaty itself was considered by the Senate a year ago, a reservation was adopted which removed article 9(4) dealing with the use of unitary taxation formulas by the individual States. I regretted and spoke against that action at the time.

The unitary taxation issue is still very much with us however, and an indication of Congress intent to deal equitably with it is key to the final ratification of the treaty by the United Kingdom.

A legislation solution to this issue is pending before the Congress and strong interest in it has been expressed by Members in both Houses. This measure, section 303 of S. 983, introduced by Senator MATHIAS, prohibits the use of the worldwide combined reporting system by the States. States would thus be required to utilize the same method of taxing multinational corporations as that utilized by the Federal Government. This change is considerably more equitable than the unitary systems now employed by a very few States and will, in my opinion, prove to be more beneficial to the economies of the States than continued or expanded use of the unitary system would be.

I understand that the Finance Committee intends to hold hearings on S. 983 and I urge my colleagues there to act expeditiously on section 303.

ESTATE AND GIFT TAX TREATY WITH THE FRENCH REPUBLIC

The PRESIDING OFFICER. The resolutions of ratification of all six protocols, conventions, and treaties having been read, the Senate will proceed to vote on the first treaty, the estate and gift tax treaty with the French Republic.

The resolution of ratification of Executive J, 96th Congress, 1st session, was read as follows:

Resolved (two-thirds of the Senators present concurring therein), That the Senate advise and consent to the ratification of the Convention Between the United States of America and the French Republic for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Estates. Inheritances and Gifts, done at Washington on November 24, 1978 (Ex. J, Ninety-sixth Congress, first session).

The PRESIDING OFFICER. (Mr. PRYOR). The question is on agreeing to the resolution of ratification of Executive J, 96th Congress, 1st session, the Estate and Gift Tax Treaty with the French Republic.

On this question the yeas and nays have been ordered, and the clerk will call the roll.

The second assistant legislative clerk called the roll.

Mr. STEVENS. I announce that the Senator from Oregon (Mr. PACKWOOD) and the Senator from South Dakota (Mr. PRESSLER) are necessarily absent.

The PRESIDING OFFICER. Are there any other Senators wishing to vote?

The yeas and nays resulted — yeas 98, nays 0, as follows:

[Rollcall Vote No. 154 Ex.]

YEAS — 98

Armstrong
Baker
Baucus
Bayh
Bellmon
Bentsen
Biden
Boren
Boschwitz
Bradley
Bumpers
Burdick
Byrd, Harry F., Jr.
Byrd, Robert C.
Cannon
Chafee
Chiles
Church
Cochran
Cohen
Cranston
Culver
Danforth
DeConcini
Dole
Domenici
Durenberger
Durkin
Eagleton
Exon
Ford
Garn
Glenn
Goldwater
Gravel
Hart
Hatch
Hatfield
Hayakawa
Heflin
Heinz
Helms
Hollings
Huddleston
Humphrey
Inouye
Jackson
Javits
Jepsen
Johnston

Kassebaum	Ribicoff
Kennedy	Riegle
Laxalt	Roth
Leahy	Sarbanes
Levin	Sasser
Long	Schmitt
Lugar	Schweiker
Magnuson	Simpson
Mathias	Stafford
Matsunaga	Stennis
McClure	Stevens
McGovern	Stevenson
Melcher	Stewart
Metzenbaum	Stone
Morgan	Talmadge
Moynihan	Thurmond
Muskie	Tower
Nelson	Tsongas
Nunn	Wallop
Pell	Warner
Percy	Weicker
Proxmire	Williams
Pryor	Young
Randolph	Zorinsky

NAYS — 0

NOT VOTING — 2

PACKWOOD PRESSLER

The PRESIDING OFFICER. Two-thirds of the Senators present and voting having voted in the affirmative, the resolution of ratification is agreed to.

Mr. CHURCH. Mr. President, I move to reconsider the vote by which the resolution of ratification was agreed to.

Mr. JAVITS. I move to lay that motion on the table.

The motion to lay on the table was agreed to.

PROTOCOL TO THE INCOME TAX CONVENTION WITH THE FRENCH REPUBLIC

The resolution of ratification of Executive K was read as follows:

Resolved, (two-thirds of the Senators present concurring therein), That the Senate advise and consent to the ratification of the 1978 Tax Protocol with the French Republic together with an exchange of notes relating thereto, done at Washington on November 24, 1978 (Ex. K, Ninety-sixth Congress, first session).

The PRESIDING OFFICER. The question is on agreeing to the resolution of ratification of Executive K, 96th Congress, first session, the protocol to the Income Tax Convention with the French Republic. On this question the yeas and nays have been ordered, and the clerk will call the roll.

The second assistant legislative clerk called the roll.

Mr. STEVENS. I announce that the Senator from Oregon (Mr. PACKWOOD) and the Senator from South Dakota (Mr. PRESSLER) are necessarily absent.

The PRESIDING OFFICER. Are there any other Senators wishing to vote?

The yeas and nays resulted — yeas 98, nays 0, as follows:

[Rollcall Vote No. 155 Ex.]

YEAS — 98

Armstrong	Burdick
Baker	Byrd, Harry F., Jr.
Baucus	Byrd, Robert C.
Bayh	Cannon
Bellmon	Chafee
Bentsen	Chiles
Biden	Church
Boren	Cochran
Boschwitz	Cohen
Bradley	Cranston
Bumpers	Culver

Danforth	McClure
DeConcini	McGovern
Dole	Melcher
Domenici	Metzenbaum
Durenberger	Morgan
Durkin	Moynihan
Eagleton	Muskie
Exon	Nelson
Ford	Nunn
Garn	Pell
Glenn	Percy
Goldwater	Proxmire
Gravel	Pryor
Hart	Randolph
Hatch	Ribicoff
Hatfield	Riegle
Hayakawa	Roth
Heflin	Sarbanes
Heinz	Sasser
Helms	Schmitt
Hollings	Schweiker
Huddleston	Simpson
Humphrey	Stafford
Inouye	Stennis
Jackson	Stevens
Javits	Stevenson
Jepsen	Stewart
Johnston	Stone
Kassebaum	Talmadge
Kennedy	Thurmond
Laxalt	Tower
Leahy	Tsongas
Levin	Wallop
Long	Warner
Lugar	Weicker
Magnuson	Williams
Mathias	Young
Matsunaga	Zorinsky

[p. 17434] NAYS — 0

NOT VOTING — 2

PACKWOOD PRESSLER

The PRESIDING OFFICER. Two-thirds of the Senators present and voting having voted in the affirmative, the resolution of ratification is agreed to.

Mr. CHURCH. Mr. President, I move to reconsider the vote by which the resolution of ratification was agreed to.

Mr. JAVITS. I move to lay that motion on the table.

The motion to lay on the table was agreed to.

THIRD PROTOCOL TO THE 1975 TAX CONVENTION WITH THE UNITED KINGDOM OF GREAT BRITAIN AND NORTHERN IRELAND, AS AMENDED

The resolution of ratification of Executive Q was read as follows:

Resolved (two-thirds of the Senators present concurring therein). That the Senate advise and consent to the ratification of the 1979 Tax Protocol with the United Kingdom of Great Britain and Northern Ireland, done at London on March 15, 1979 (Ex. Q, Ninety-sixth Congress, first session).

The PRESIDING OFFICER. The question is on agreeing to the resolution of ratification on Executive Q, 96th Congress, first session, the third protocol to the 1975 Tax Convention with the United Kingdom of Great Britain and Northern Ireland, as amended. On this question the yeas and nays have been ordered, and clerk will call the roll.

The second assistant legislative clerk called the roll.

Mr. STEVENS. I announce that the Senator from Oregon (Mr. PACKWOOD) and the Senator from South Dakota (Mr. PRESSLER) are necessarily absent.

The PRESIDING OFFICER. Are there any other Senators wishing to vote?

The yeas and nays resulted — 98, nays 0, as follows:

[Rollcall Vote No. 156 Ex.]

YEAS — 98

Armstrong
Baker
Baucus
Bayh
Bellmon
Bentsen
Biden
Boren
Boschwitz
Bradley
Bumpers
Burdick
Byrd, Harry F., Jr.
Byrd, Robert C.
Cannon
Chafee
Chiles
Church
Cochran
Cohen
Cranston
Culver
Danforth
DeConcini
Dole
Domenici
Durenberger
Durkin
Eagleton
Exon
Ford
Garn
Glenn
Goldwater
Gravel
Hart
Hatch
Hatfield
Hayakawa
Heflin
Heinz
Helms
Hollings
Huddleston
Humphrey
Inouye
Jackson
Javits
Jepsen
Johnston
Kassebaum
Kennedy
Laxalt
Leahy
Levin
Long
Lugar
Magnuson
Mathias
Matsunaga
McClure
McGovern
Melcher
Metzenbaum
Morgan
Moynihan
Muskie
Nelson
Nunn
Pell

Percy
Proxmire
Pryor
Randolph
Ribicoff
Riegle
Roth
Sarbanes
Sasser
Schmitt
Schweiker
Simpson
Stafford
Stennis
Stevens
Stevenson
Stewart
Stone
Talmadge
Thurmond
Tower
Tsongas
Wallop
Warner
Welcker
Williams
Young
Zorinsky

NAYS — 0

NOT VOTING — 2

PACKWOOD PRESSLER

The PRESIDING OFFICER. Two-thirds of the Senators present and voting having voted in the affirmative, the resolution of ratification is agreed to.

Mr. CHURCH. Mr. President, I move to reconsider the vote by which the resolution of ratification was agreed to.

Mr. JAVITS. I move to lay that motion on the table.

The motion to lay on the table was agreed to.

ESTATE AND GIFT TAX TREATY WITH THE UNITED KINGDOM OF GREAT BRITAIN AND NORTHERN IRELAND

The resolution of ratification of Executive R was read as follows:

Resolved (two-thirds of the Senators present concurring therein). That the Senate advise and consent to the ratification of the Convention Between the Government of the United States of America and the Government of the United Kingdom of Great Britain and Northern Ireland for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes

on Estates of Deceased Persons and on Gifts, done at London on October 19, 1978 (Ex. R, Ninety-sixth Congress, first session).

The PRESIDING OFFICER. The question is on agreeing to the resolution of ratification on Executive R, 96th Congress, first session, the Estate and Gift Treaty with the United Kingdom of Great Britain and Northern Ireland. On this question the yeas and nays have been ordered, and the clerk will call the roll.

The second assistant legislative clerk called the roll.

Mr. STEVENS. I announce that the Senator from Oregon (Mr. PACKWOOD) and the Senator from South Dakota (Mr. PRESSLER) are necessarily absent.

The PRESIDING OFFICER. Are there any other Senators wishing to vote?

The yeas and nays resulted — yeas 98, nays 0, as follows:

[Rollcall Vote No. 157 Ex.]

YEAS — 98

Armstrong
Baker
Baucus
Bayh
Bellmon
Bentsen
Biden
Boren
Boschwitz
Bradley
Bumpers
Burdick
Byrd, Harry F., Jr.
Byrd, Robert C.
Cannon
Chafee
Chiles
Church
Cochran
Cohen
Cranston
Culver
Danforth
DeConcini
Dole
Domenici
Durenberger
Durkin
Eagleton
Exon
Ford
Garn
Glenn
Goldwater
Gravel
Hart
Hatch
Hatfield

Hayakawa
Heflin
Heinz
Helms
Hollings
Huddleston
Humphrey
Inouye
Jackson
Javits
Jepsen
Johnston
Kassebaum
Kennedy
Laxalt
Leahy
Levin
Long
Lugar
Magnuson
Mathias
Matsunaga
McClure
McGovern
Melcher
Metzenbaum
Morgan
Moynihan
Muskie
Nelson
Nunn
Pell
Percy
Proxmire
Pryor
Randolph
Ribicoff
Riegle
Roth
Sarbanes
Sasser
Schmitt
Schweiker
Simpson
Stafford
Stennis
Stevens
Stevenson
Stewart
Stone
Talmadge
Thurmond
Tower
Tsongas
Wallop
Warner
Welcker
Williams
Young
Zorinsky

NAYS — 0

NOT VOTING — 2

PACKWOOD
PRESSLER

The PRESIDING OFFICER. Two-thirds of the Senators present and voting having voted in the affirmative, the resolution of ratification is agreed to.

Mr. CHURCH. Mr. President, I move to reconsider the vote by which the resolution of ratification was agreed to.

Mr. JAVITS. I move to lay that motion on the table.

The motion to lay on the table was agreed to.

TAX CONVENTION WITH THE REPUBLIC OF KOREA

The resolution of ratification of Executive P was read as follows:

Resolved (two-thirds of the Senators present concurring therein), That the Senate advise and consent to the ratification of the 1976 Tax Convention with the Republic of Korea, together with an exchange of notes relating thereto, signed at Seoul on June 4, 1976 (Executive P, Ninety-fourth Congress, second session).

The PRESIDING OFFICER. The question is on agreeing to the resolution of ratification on Executive P, 94th Congress, 2d session, the Tax Convention with the Republic of Korea. On this question the yeas and nays have been ordered, and the clerk will call the roll.

The second assistant legislative clerk called the roll.

Mr. STEVENS. I announce that the Senator from Oregon (Mr. PACKWOOD) and the Senator from South Dakota (Mr. PRESSLER) are necessarily absent.

The PRESIDING OFFICER. Are there any other Senators wishing to vote?

The yeas and nays resulted — yeas 98, nays 0, as follows:

[Rollcall Vote No. 158 Ex.]

YEAS — 98

Armstrong
Baker
Baucus
Bayh
Bellmon
Bentsen
Biden
Boren
Boschwitz
Bradley
Bumpers
Burdick

Byrd, Harry F., Jr.
Byrd, Robert C.
Cannon
Chafee
Chiles
Church
Cochran
Cohen
Cranston
Culver
Danforth
DeConcini
Dole
Domenici
Durenberger
Durkin
Eagleton
Exon
Ford
Garn
Glenn
Goldwater
Gravel
Hart
Hatch
Hatfield
Hayakawa
Heflin
Heinz
Helms
Hollings
Huddleston
Humphrey
Inouye
Jackson
Javits
Jepsen
Johnston
Kassebaum
Kennedy
Laxalt
Leahy
Levin
Long
Lugar
Magnuson
Mathias
Matsunaga
McClure
McGovern
Melcher
Metzenbaum
Morgan
Moynihan
Muskie
Nelson
Nunn
Pell
Percy
Proxmire
Pryor
Randolph
Ribicoff
Riegle
Roth
Sarbanes
Sasser
Schmitt
Schweiker
Simpson
Stafford
Stennis
Stevens
Stevenson
Stewart
Stone
Talmadge
Thurmond

Tower
Tsongas
Wallop
Warner
Welcker
Williams
Young
Zorinsky

NAYS — 0

NOT VOTING — 2

PACKWOOD PRESSLER

The PRESIDING OFFICER. Two-thirds of the Senators present and voting having voted in the affirmative, the resolution of ratification is agreed to.

Mr. CHURCH. Mr. President, I move to reconsider the vote by which the resolution of ratification was agreed to.

Mr. JAVITS. I move to lay that motion on the table.

[p. 17435] The motion to lay on the table was agreed to.

TAX CONVENTION WITH THE HUNGARIAN PEOPLE'S REPUBLIC

The resolution of ratification of Executive X was read as follows:

Resolved (two-thirds of the Senators present concurring therein), That the Senate advise and consent to the ratification of the Convention Between the Government of the United States of America and the Government of the Hungarian People's Republic for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, together with an exchange of notes relating thereto, done at Washington on February 12, 1979 (Ex. X, Ninety-sixth Congress, first session).

The PRESIDING OFFICER. The question is on agreeing to the resolution of ratification on Executive X, 96th Congress, 1st session, the Tax Convention with the Hungarian People's Republic. On this question the yeas and nays have been ordered, and the clerk will call the roll.

The second assistant legislative clerk called the roll.

Mr. STEVENS. I announce that the Senator from Oregon (Mr. PACKWOOD) and the Senator from South Dakota (Mr. PRESSLER) are necessarily absent.

The PRESIDING OFFICER. Are there any other Senators wishing to vote?

The yeas and nays resulted — 98 yeas, nays 0, as follows:

[Rollcall Vote No. 159 Ex.]

YEAS — 98

Armstrong
Baker
Baucus
Bayh
Bellmon
Bentsen
Biden
Boren
Boschwitz
Bradley
Bumpers
Burdick
Byrd, Harry F., Jr.
Byrd, Robert C.
Cannon
Chafee
Chiles
Church
Cochran
Cohen
Cranston
Culver
Danforth
DeConcini
Dole
Domenici
Durenberger
Durkin
Eagleton
Exon
Ford
Garn
Glenn
Goldwater
Gravel
Hart
Hatch
Hatfield
Hayakawa
Heflin
Heinz
Helms
Hollings
Huddleston
Humphrey
Inouye
Jackson
Javits
Jepsen
Johnston
Kassebaum
Kennedy
Laxalt
Leahy
Levin
Long
Lugar
Magnuson

Mathias	Sasser
Matsunaga	Schmitt
McClure	Schweiker
McGovern	Simpson
Melcher	Stafford
Metzenbaum	Stennis
Morgan	Stevens
Moynihan	Stevenson
Muskie	Stewart
Nelson	Stone
Nunn	Talmadge
Pell	Thurmond
Percy	Tower
Proxmire	Tsongas
Pryor	Wallop
Randolph	Warner
Ribicoff	Welcker
Riegle	Williams
Roth	Young
Sarbanes	Zorinsky

NAYS — 0

NOT VOTING — 2

PACKWOOD PRESSLER

The PRESIDING OFFICER. Two-thirds of the Senators present and voting having voted in the affirmative, the resolution of ratification is agreed to.

Mr. CHURCH. Mr. President, I move to reconsider the vote by which the resolution of ratification was agreed to.

Mr. JAVITS. I move to lay that motion on the table.

The motion to lay on the table was agreed to.

Mr. CHURCH. Mr. President, I move that the President be immediately notified.

The PRESIDING OFFICER. Without objection, it is so ordered.

* * *

[p. 17796] UNITED STATES-UNITED KINGDOM TAX TREATY

• Mr. HAYAKAWA. Mr. President, as indicated last June 1978, I favored the United States-United Kingdom Tax Treaty with article 9(4) included, because I am opposed to the application of combined reporting to multinational corporations. When applied in a multi-corporate setting, the doctrine of combined reporting requires that a corporation with a business location in the States include in its apportionable tax base not only the entire income of such corporations within the State, but also the income of such of its worldwide affiliates as are found by the State to participate with the corporation in a single business unit. This broad approach to corporation taxation by a State of the income of corporations that have no real contact or connection with the State can result in more than 100 percent of a company's income being subjected to State taxation or can result in a company paying that or an allocable portion of the entire income of another corporation, even though there is not complete unity of ownership between the two corporations. I also feel that such taxation doctrine impinges on the foreign relations of the United States.

During our deliberations concerning this treaty last summer, much was said about legislatively involving both Houses of Congress. Now that we have removed article 9(4) from the treaty we have an opportunity as provided by section ??? of Senator MATHIAS' Interstate Taxation Act, S. 983, to address the situation legislatively and I am glad that we did yesterday with the deliberation.•

EXHIBIT 36C

UNITED STATES OF AMERICA
Congressional Record

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* * *

[p. 18402] TAX CONVENTION WITH THE UNITED KINGDOM OF GREAT BRITAIN AND NORTHERN IRELAND — EXECUTIVE K. 94TH CONGRESS, 2D SESSION.

The Senate continued with the consideration of the treaty.

Mr. SPARKMAN. Mr. President, I ask unanimous consent that the United Kingdom-United States Treaty be considered as having passed through its various parliamentary stages up to and including the presentation of the resolution of ratification.

The PRESIDING OFFICER. Without objection, it is so ordered. The clerk will state the resolution of ratification.

The legislative clerk read as follows:

Resolved. (two-thirds of the Senators present concurring therein). That the Senate advise and consent to the ratification of the Convention Between the Government of the United States of America and the Government of the United Kingdom of Great Britain and Northern Ireland for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income signed at London on December 31, 1975, and an Exchange of Notes signed at London on April 13, 1976, modifying certain provisions of the Convention (Executive K, 94th Congress, second session), and by two protocols, signed on August 26, 1976 (Executive Q, 94th Congress, second session) and on March 31, 1977 (Executive J, 95th Congress, first session).

* * *

Mr. SPARKMAN. Mr. President, I am pleased to present to the Senate the proposed United States-United Kingdom Income Tax Treaty, as amended by an exchange of notes and two protocols. On March 15, 1978, the Committee on Foreign Relations recommended that the Senate give its advice and consent to the treaty and the protocols.

The proposed treaty is intended to replace the existing treaty which was originally signed in 1945. The British House of Commons has already approved the new treaty and protocols. The treaty properly reflects the significance of our close and extensive economic relations with the United Kingdom and is designed to update existing arrangements.

In keeping with other income tax treaties, the proposed treaty contains basic provisions that are designed to avoid double taxation and to prevent evasion of income taxes. However, the treaty breaks new ground in several fundamental respects.

The agreement to refund the United Kingdom advanced corporation tax represents a major concession by the British. Under the new British system of integrated taxation, a tax, known as the A.C.T., is imposed upon divided payments of United Kingdom

corporations. The tax is then refunded to British shareholders, but not to other foreign shareholders.

This treaty proposes that U.S. shareholders be given a similar refund, thus eliminating the current discrimination against U.S. investors. The Joint Committee on Taxation has estimated that the refund of this tax will return approximately $375 million to individual and corporate U.S. investors for the years 1973-78, and approximately $90 million a year thereafter. In short, the refund of the tax will provide substantial rebates to American investors and create new investment incentives for our investors. In addition, the treaty commits the United States to reduce its withholding tax rates on dividends paid by American corporations to British investors.

A second new provision of the proposed treaty, contained in article 9(4), seeks to limit the application of the unitary apportionment method in assessing the State income tax liability of any corporation that is controlled by British investors. The proposed treaty provides that a State may not take into account the operations of any affiliated corporation that is not doing business in that State. Rather, the States will be empowered only to utilize the arm's length method, a formula used by the Federal Government and many foreign governments.

* * *

[p. 18403] In most other areas, the proposed treaty is substantially similar to the existing tax treaty with the United Kingdom to other recent U.S. tax treaties and to the model tax treaty of the organization for economic cooperation and development

The proposed tax treaty is vitally important in furthering the objectives of our international economic policies. These objectives are concerned with the removal of impediments to the free international flow of capital and technology, the prevention of tax evasion, and removal of differential tax rates that discriminate against American investors. Of particular significance, the treaty provides for substantial economic refunds to American investors. In a major concession, the British have agreed to make these refunds retroactive, which will immediately provide $375 million

to our investors for the years 1973 through 1978, and $90 million per year thereafter.

* * *

The United Kingdom is one of our major trading partners with whom we have shared close economic relations for many years. Vast changes have occurred in this relationship since 1945, when the existing treaty was first signed. The treaty serves to update outmoded tax laws and institute internationally recognized standards in the area of tax administration. The arm's length method in article 9(4) is one such uniformly accepted standard and thus simplifies the administrative complexities in the determination of taxable income of United Kingdom corporations.

* * *

Mr. President, I ask unanimous consent that excerpts from the committee report be printed in the RECORD at this point.

There being no objection, the excerpts were ordered to be printed in the RECORD, as follows:

INCOME TAX TREATY WITH THE UNITED KINGDOM AND TWO PROTOCOLS REPORT

* * *

II. BACKGROUND

The proposed Tax Treaty with the United Kingdom was signed on December 31, 1975, and was amended by the Exchange of Notes (signed on April 13, 1976), the first Protocol (signed August 26, 1976) and the second Protocol (signed on March 31, 1977). The Tax Treaty and the Exchange of Notes were transmitted to the Senate on June 24, 1976.

The proposed Tax Treaty, as amended by the Exchange of Notes and the two Protocols, has been approved by the United Kingdom House of Commons.

III. Summary of Treaty

The proposed treaty is substantially similar to the existing tax treaty with the United Kingdom, to other recent U.S. tax treaties, and to the model tax treaty of the Organization for Economic Cooperation and Development (OECD). There are, however, several provisions of the proposed treaty which are not found in other U.S. tax treaties. Of particular significance are the new provisions contained in the proposed treaty (1) which provide for a refund by the U.K. to U.S. portfolio and direct shareholders receiving dividends from British corporations of Advance Corporation Tax (ACT) paid by the distributing corporation (*Article 10*) and allow a U.S. foreign tax credit for the one-half of the ACT which is not refunded to U.S. direct corporate investors (*Article 23*), (2) which limit the right of states to apportion income of British multinational corporations under the unitary method (*Article 9(4)*), and (3) which treat the British Petroleum Revenue Tax (PRT) as a creditable tax for U.S. foreign tax credit purposes (*Articles 2 and 23*).

IV. Provisions of Treaty

* * *

Article 5. Permanent establishment

Article 5 defines the term permanent establishment for purposes of the treaty. The manner in which income of a resident of one country is taxed by the other country is generally dependent upon whether the income [p. 18404] is attributable to a permanent establishment which the resident has in that other country.

* * *

Article 7. Business profits

Article 7 defines the term "business profits" and provides the general rule that residents of one country are not to be taxed on business profits from the other country unless they are attributable to a permanent establishment in that other country.

* * *

Article 9. Associated enterprises

Article 9 sets forth the right of each country to allocate income on an arm's-length basis in the case of transactions between related persons.

Article 9(4). State taxation/unitary method

The proposed treaty contains a new provision, not fund in other United States tax treaties, which places limitations on the combined reporting method used by several states of the United States to determine the taxable income which multinational corporations derive from sources within the state. Under this apportionment method, the operations of all related corporations (both domestic and foreign) are taken into account on a consolidated basis. The proposed treaty provides generally that in determining the tax liability of a British corporation doing business within a state, or of any subsidiary (U.S. or foreign) doing business within a state which is controlled by a British corporation, the state may not use the combined reporting method to take into account the operations of any related foreign corporation which is not doing business within the state. In such cases, the arm's-length method may be applied.

* * *

[p. 18405] VII. Committee Action

The Committee considered the proposed treaty on March 15, 1978, and ordered it favorably reported by a voice vote with the recommendation that the Senate give its advice and consent to ratification of the proposed treaty. Prior to the vote. Senator Church proposed that a reservation be attached to the provision that restricts the use of the unitary taxing method. Article 9(4). The proposed reservation on Article 9(4) was defeated by a vote of 10 to 5. The Senators favoring a reservation were Senators Church, Clark, Humphrey, Sarbanes, and Sparkman. The Senators opposing a reservation were Senators Baker, Case, Glenn, Griffin, Javits, McGovern, Pearson, Pell, Percy, and Stone.

* * *

[p. 18408] *Article 9. Associated enterprises*

The proposed treaty, like most other U.S. tax treaties, contains a provision similar to that contained in the Internal Revenue Code (sec. 482) which recognizes the right of each country to make an allocation of income in the case of transactions between related persons. If an allocation is necessary to reflect the conditions and arrangements which would have been made between unrelated persons.

It is anticipated that when a redetermination has been made by one country with respect to the income of a related person, the other country will attempt to reach an agreement with the first country in connection with the redetermination, and if it agrees with the redetermination, it will make a corresponding adjustment to the income of the other person.

Limitation on State Taxation

The proposed treaty also containes a new provision, not found in other United States treaties, which limits the methods by which the United States, the United Kingdom, and political subdivisions and local authorities of each country may tax enterprises of the other country (or enterprises which are directly or indirectly controlled by enterprises of the other county). The proposed treaty provides that in determining the tax liability of such an enterprise doing business within their respective jurisdictions, the United States, the United Kingdom and their political subdivisions and local authorities may not take into account the income, deductions, receipts or outgoings of a related enterprise of the other country or of any third country.

Background.—This provision applies to those states of the United States which, in determining the amount of income of a business operating within the state which is to be apportioned to that state for income tax purposes, require combined reporting of all related business operations (including related business operations of affiliated U.S. and foreign corporations, whether or not doing business within the state). The governments of the United Kingdom and the United States do not apportion income between jurisdictions under this method but rather allocate income between relaed enterprises under arm's-length principles as specified in other paragraphs of this article. In addition, the political subdivisions and local authorities of the United Kingdom do not impose income taxes. Consequently, this provision's only application is to limit the combined reporting method used by certain states of the United States.

In determining what business income of a corporation is earned within a state and thus subject to income tax by that state, all states imposing an income tax use some type of apportionment system. An apportionment system is necessary because of the difficulties of attempting to account separately for business income in any state where the activities of a single business are carried on beyond the borders of that one state. In most states this business income is apportioned between the state and other jurisdictions according to a basic three-factor formula (or some variation of the formula) under which total business income is multiplied by the average ratio of sales, payroll, and property values within the state to total sales, payroll, and property values associated with the business. This type of apportionment, when applied to a single business of one corporation, is called the "unitary method" of apportionment and is used by most states which have a corporate income tax. The proposed treaty does not affect the application of this method when applied to a single corporation.

However, some states have adopted "combined reporting" requirements, which extend the unitary method to corporations related to the corporation doing business within the state (subsidiaries, parent corporations, or brother-sister corporations), whether or not these related corporations are doing business within the state, where the activities of the related corporations are considered by the state to constitute a unitary business. For example, if a U.K. manufacturing company operating in a state requiring combined reporting owns a U.S. subsidiary which sells the products manufactured by the U.K. parent, the income subject to tax in that state would be determined under the combined reporting method by applying the average ratio of the sales, payroll, and property values in the state to total sales, payroll, and property values of both corproations in both countries

and multiplying these average ratios against the combined worldwide income of the two corporations.

California, Oregon, and Alaska are the primary states requiring the use of combined reporting in connection with related foreign corporations as well as related domestic corporations. Certain other state governments have also indicated that combined reporting with respect to related foreign corporations is at times required in their states, or that they may in the future require this type of reporting at least in some cases.

Explanation of limitation—The treaty provision prevents a state from extending the unitary method through this combined reporting system to related foreign enterprises where the enterprise doing business in the state is either a British enterprise or is controlled directly or indirectly by a British enterprise. Thus, for example, if a U.S. branch of a British corporation does business in a state, that state cannot apply the unitary method to combine the income (and sales, payroll, and property) of any related foreign enterprises (from the United Kingdom or any third country) with those of that British corporation in determining the income of its U.S. branch which is taxable by that state. However, that state may take into account the income and assets of any other branches of that corporation wherever located, because a corporation is considered to be a single enterprise regardless of how many separate branches or businesses it has. Alternatively, if the British corporation does not do business in the state but has a U.S. subsidiary (or any other corporation which it directly or indirectly controls) doing business in the state, that state, in determining the taxable income of that U.S. subsidiary, cannot apply combined reporting requirements to include the income (and the sales, payroll, and property values) of the British parent corporation or other related foreign enterprises. Of course, in either situation described above the state may take into account the income and assets of any related U.S. corporations.

The limitation in Article 9(4) applies only to cases where an apportionment formula is used without regard to any application of the arm's-length standard (provided under *Article 9(1)*). Of course, both countries and their political subdivisions may apply apportionment formulas, including formulas that take into account attributes of related entities, as a method of achieving an arm's-length price for a transaction between related entities. Moreover, apportionment formulas may be used as a method of apportioning income of related entities to the extent that it is established that they are not dealing on an arm's length basis.

There are two additional exceptions to the combined reporting limitation. First, if the British enterprise is a corporation which is itself directly or indirectly controlled by residents of the United States (Code sec. 957) or of any third country, the limitation does not apply. In addition, in computing the tax liability of any U.S. subsidiary (or other enterprise) resident in the state which is controlled by a British enterprise, the three factor formula may, notwithstanding the general prohibition, be applied to any related foreign enterprise to the extent that the U.S. subsidiary owns, directly or indirectly, the capital of the related foreign enterprise.

For purposes of the proposed treaty, an enterprise is related to another enterprise if either enterprise directly or indirectly controls the other, or if any third person or persons (related to each other or acting together) control both. The term control is not limited to the ownership of the capital of an enterprise, and it includes any kind of control, whether or not legally enforceable, however exercised or exercisable.

* * *

[p. 18415] Mr. SPARKMAN. Mr. President, I am in unanimous consent that an editorial [p. 18416] from the Wall Street Journal and an editorial from the New York Times be printed in the RECORD.

There being no objection, the material was ordered to be printed in the RECORD as follows:

[From the Wall Street Journal, May 10, 1978]

NOW, THE U.K. TAX TREATY

Out of the corner of your eye, no doubt, you have been seeing stories and commentaries about the tax treaty our State Department negotiated with the United Kingdom. In the next day or so, most likely, the U.S. Senate will vote the treaty up or down. We

and almost everyone else who has looked at the treaty think it is swell, a document that so clearly benefits all parties that it may be that which Milton Friedman says there is none of, a free lunch.

Why are the proponents so anxious? What's it all about?

In the most general terms, what the treaty does is protect British investors from the tendency of American tax collectors to become greedy and arbitrary. At the same time it protects American investors from the tendency of British tax collectors to become greedy and arbitrary.

The folks who are trying to dynamite the treaty in the U.S. Senate, not surprisingly, are the state tax collectors, who are running around yelling that the treaty is a violation of "states' rights" and will cause a loss of revenues to state governments.

There is, broadly speaking, no merit to their arguments although they have a measure of our sympathy. They are constantly being whipped by their political bosses to find revenues that do not anger voters. It is thus inevitable that they would be driven to plucking the feathers of foreign investors, which is precisely why it became necessary for the State Department to get into the act and negotiate this treaty.

All it takes in a state revenue office to show a short-run bulge in taxes is to move the puncuation around in the accounting rules that U.S. subsidiaries of foreign companies must follow. Once the company is established, say in California, Sacramento has a tendency to figure it has no choice but to stand still and be plucked. This is the same mental attitude that once gripped the banana republics of Latin America, until they learned that greedy plucking of foreign investors always meant a drying up of foreign investment.

State tax collectors are not expected to understand the global impact of their narrow-minded administrative manipulations. National politicians are expected to, which is why there is such broad support in Washington and New York among Democrats and Republicans and newspapers that are usually on opposite sides of issues. In California, Gov. Jerry Brown initially sided with his tax collector. Then he took a trip to Japan and realized that potential

Japanese investors in the California economy were staying home. Now he supports the treaty.

All the treaty does is systematize procedures in a way that will prevent states from abusing their tax-collecting powers in a way that ultimately hurts everyone, including their own citizens. The worst abuse tax that will be halted is the state taxing of profits earned outside a state, even profits earned in the United Kingdom. For their part, our British partners will stop double-taxing U.S. dividend income and rebate a barrel of money already grabbed in this fashion. If this isn't a free lunch, it's at least the next best thing.

[From the New York Times, May 9, 1978]

THE NATIONAL STAKE IN A TAX TREATY

For a generation, except in the recession year of 1977, the exports of the industrial countries have been climbing annually about twice as fast as production, spurring growth rates, income and prosperity. That growth has depended on the reduction of barriers to international trade and investment, but many impediments remain. One of them is the discriminatory taxation of American investments abroad, and it can be significantly reduced if the Senate this week approves a new tax treaty with Britain. It would also reduce discriminatory taxation of British companies in the United States: unfortunately, it is opposed by several state governments that fear the loss of revenue. The two-thirds vote needed for ratification is in doubt.

The pending pact, arduously negotiated over three years, would replace and modernize a 1945 treaty. The major gain for American investors is a provision that would grant them relief from the double taxation of business income as it appears as corporate earnings and dividends. Britons now get such relief in the form of tax credits; the new treaty would qualify Americans for cash refunds and put them on much the same footing.

Refunds of about $85 million a year are at stake. A retroactive payment of $375 million for the 1973-78 period would also be made — a not-insignificant boost for the dollar, as the Treasury has observed. Moreover, the treaty would set a standard for

similar negotiations with West Germany, France, Canada and other nations. Its approval clearly would serve American interests.

Because the United States continues to tax both corporate earnings and dividend distributions, it had to offer Britain other concessions to gain the treaty. The one that has aroused the greatest opposition would limit a type of taxation by state governments that discriminate against subsidiaries of British companies. Several governors have invoked the cry of "states" rights to challenge the treaty. Tax officials of a dozen states have written to President Carter protesting that such treaties would significantly reduce the revenues of 32 states and also create a chance for tax evasion by American-controlled multinational companies.

The treaty would prohibit states from taxing subsidiaries for any part of the income of a parent company outside the state. However, the Treasury would help the states to apply the complicated "arms length" calculations used by the Federal Government to guard against the understating of a subsidiaries profits. A letter from Treasury Secretary Blumenthal to the 50 governors argues persuasively that this should adequately protect their taxing power. Mr. Blumenthal also argues that the revenue losses are likely to be small and probably be offset by new investments that the present system now discourages. He offers assurances that present taxing methods would continue to apply to American-controlled multinational companies.

California, with the largest stake in the present system, is now supporting ratification. Governor Brown evidently discovered on a trip to Tokyo that prospects for Japanese assembly plants and other investments in California would be improved by such tax changes. The national interest, too, will be served if the Senate rejects the proposed reservations and approve the treaty.

Mr. SPARKMAN. Mr. President, I believe that Senator Church is prepared to make remarks on this treaty and I yield to him.

The PRESIDING OFFICER. The Senator from Idaho is recognized.

UP RESERVATION NO. EX-40

(Subsequently numbered reservation No. Ex.-1.)

MR. CHURCH. Mr. President, I send to the desk a reservation to the pending treaty which relates to article 9(4) and ask that it be stated.

The PRESIDING OFFICER. The clerk will state the reservation.

The legislative clerk read as follows:

The Senator from Idaho (Mr. Church) proposes an unprinted reservation numbered Ex-40:

Before the period at the end of the resolution of ratification insert a comma and the following: "subject to the reservation that the provisions of paragraph (4) of Article 9, as amended by the Notes relating to the Convention which were exchanged on April 13, 1976, shall not apply to any political subdivision or local authority of the United States."

The PRESIDING OFFICER. There are 4 hours on the reservation.

Mr. CHURCH. I yield myself such time as I may require.

Mr. President, before the Memorial Day recess, Members of the Senate received a letter urging them to oppose this reservation of article 9(4) of the proposed United States-United Kingdom Tax Treaty. The letter repeated arguments in support of the treaty which, in my judgment, do not withstand close analysis. I would like at this time to respond to those arguments.

There are two important principles at stake in this treaty. The first concerns the role of tax treaties in our constitutional system. Whatever tax treaties are good for, they should not be used to usurp for the executive branch of Government the power to impose major changes in internal tax policy. Yet, the United Kingdom Treaty does precisely this.

For some 10 years, Congress has been rejecting the type of limitation on the power of our State governments to tax which is incorporated in article 9(4) of the pending treaty. Yet, if this article is adopted, it will serve as a precedent for the future.

No one has suggested that this provision would be confined to the bilateral agreement between the United States and the United Kingdom. It is anticipated, should this provision remain in the treaty, that it will be inserted in all future treaties with other foreign governments, and we must consider it in this light.

In due course, the executive branch, through the device of these many new tax treaties, actually will work a change in our internal tax laws, imposing for the first time a limitation upon the right of State governments to choose the method by which they tax foreign-owned corporations doing business within their jurisdictions. And that change of policy will be accomplished without consultation with the States that are affected, without any participation on their part — indeed, without the consent of the Congress of the United States and without action by the appropriate tax committees of the House of Representatives and the Senate.

Many words have been spoken about the need for Congress to reassert its rightful legislative prerogatives. Yet, the United States-United Kingdom Treaty now before us represents legislative policymaking by the executive through the device of a tax treaty.

The second important principle concerns [p. 18417] the proper way for resolving disputes within our federal system. As I mentioned a moment ago, the States were never consulted before their tax powers were bargained away for the benefits of the multinational corporations. They were informed afterward, and then only through happenstance, when they suddenly discovered this provision, article 9(4), in the treaty now before us.

Mr. President, Congress is the forum in which disputes within the federal system meant to be resolved. In Congress, both sides can make their case, and reasonable compromises are possible. Ironically, the letter from supporters of article 9(4) suggests that the principle of resolving Federal disputes within Congress rather

than through the treaty process "is an attack on the exercise by the Senate of its power to give advice and consent on tax treaties."

Mr. President, that assertion lacks both logic and historical truth. The original purpose for the Senate's role in the treaty process was to protect the interests of the several States in treaty matters. The framers feared that to give the executive branch of the Federal Government free rein in the treaty process would enable the President to ride roughshod over the States. We may have waited a while to see that fear confirmed, but that is exactly what article 9(4) of this treaty does. It demonstrates that the fears of the framers of our Constitution were well founded.

Mr. President, multinational corporations have a long list of disputes with the States, not only in the tax area but in other areas as well — natural gas development, offshore drilling, land use, environmental standards, corporate and foreign ownership of farmland, among others.

If we consent to this precedent-setting article 9(4) of the United Kingdom Treaty, we invite the use of the treaty process in the future, without participation of the States, to settle these many other points of controversy.

Those of us in the Senate who oppose article 9(4) are not alone in our concern for these principles. The same provision is strongly opposed by the California Comptroller and the Franchise Tax Board; by the Governors of Alaska and Oregon and 16 other States, including my own - by some 26 State tax commissioners; by the AFL-CIO; by the Consumer Federation of America; by the American Federation of State, County, and Municipal Employees; by the National Association of Machinists and Aerospace Workers; by the Oil, Chemical, and Atomic Workers International Union; by the National Farmers Union, and by the National Democratic Committee's Farm Caucus.

This provision in the treaty is supposed to be justified by the alleged abuses said to have occurred in the State of California in its application of the unitary method for taxing the multinational corporations doing business in that State.

Mr. President, if we were to set aside the question of whether or not these allegations are well founded and were to assume, for the purpose of argument, that abuses may have occurred in California, the fact remains that similar charges have not been made against any other State that has adopted the unitary method. In our hearings, there were no such charges alleged against the other 42 States and the District of Columbia which are presently using all, part, or a variation of the unitary method in determining the tax to be assessed against a multinational corporation.

So all we have to justify this article is the charge that in certain instances the determinations made by the State of California were abusive and worked to the disadvantage of the large companies there.

I think that is a very thin basis upon which to justify the inclusion in this treaty of an article of this kind, for the treaty is not confined to the State of California. It limits the power of every State government to determine the method to be used in taxing foreign-owned corporations doing business within the State.

Furthermore, Mr. President, if any given State applies the unitary method in a way that business finds to be onerous there are remedies that are available. Until now we had always thought those remedies sufficient. In the first place, the business concern can effect its own remedy by simply withdrawing from the State and taking its business elsewhere. Or the State legislature, faced with complaints of this kind, can readily refashion its law so as not to cause an exodus of capital.

For 200 years now we had thought that this self-correcting process was sufficient. We had thought that it was unnecessary for the Federal Government to intervene via a treaty with a foreign government to prohibit all the States from adopting the unitary method to tax these great global corporations.

I think we will regret the precedent established by this treaty if the Senate chooses not to strike article 9(4) from the treaty by way of the reservation I propose.

Finally, Mr. President, there is the question of the revenue impact of the United Kingdom Treaty on the United States. The Treasury Department states:

The overall impact on Federal tax revenues of the changes from the present U.K. Treaty is expected to be no more than a few million dollars.

Mr. President. I cannot find any basis for such a statement. The Congessional Budget Office judges that the 5-year cost of the United Kingdom Treaty in millions of dollars to be as follows: The revenue loss for 1978 to the Federal Treasury will be $100 million; in 1979, $28 million; in 1980, $31 million; in 1981, $35 million; in 1982, $40 million; and in 1983, $45 million.

The Budget Office made no estimate of the potential revenue loss to the United States from making creditable dollar for dollar against U.S. taxes, Britain's advance corporation tax, known as the ACT or its petroleum revenue tax, known as the PRT.

The revenue effect section of the Foreign Relations Committee report on the United Kingdom Treaty indicates that by making those taxes creditable, the potential loss of the ACT is somewhere between $50 million and $100 million for the 1975-78 period, and $15 million to $25 million a year thereafter. The potential revenue loss from the PRT ranges from between $300 million and $600 million a year by 1983.

These are very sizable losses. Further, these figures are confined only to the impact of this treaty between the United States and the United Kingdom.

But what will be the real loss to the U.S. Treasury? When the principles incorporated in this treaty are extended to all new tax treaties between the United States and all other foreign governments, the global tax loss to the U.S. Treasury will be staggering.

In summary, Mr. President, it is clear that the executive branch is attempting to induce the Senate to approve an undesirable treaty that will have high costs to the U.S. Government, and to use the treaty process both for the initiation of new tax policy within the United States and for the resolution of disagreements within the Federal system.

We have lived to regret past concessions of our legislative roll and we will live to regret again any decision that retains article 9(4) in the pending treaty.

Mr. President, one of the States that has adopted the unitary method of taxing foreign-owned corporations is the State of Alaska. My attention has been called to a very interesting advertisement of the Exxon Co., which was published in Alaska in which the following two questions and answers appear:

Question. How does the State determine how much of a multistate company's income is taxable in Alaska?

ANSWER. Under current law a multistate or multinational corporation's total world-wide income is apportioned to Alaska by an equally weighted three-factor formula based on the percentage of the company's total property, payroll, and sales in the State. For instance, if the company has 25 percent of its total property, payroll and sales in Alaska, the company pays Alaska corporate income taxes on 25 percent of its total Federal taxable income — at the corporate tax rate of 9.4 percent. Variations of this same formula are used in 42 other States and the District of Columbia in calculating income to attribute to multistate companies.

Question. Would Alaska change the formula under the legislation now proposed?

ANSWER. Yes. One bill would delete the sales factor and substitute an extraction factor. Supporters of the measure ignore the fact that production activity (extraction) is measured by the property and payroll factors and that Alaska also already levies a high tax on production through the severance tax. Another proposal is a separate accounting bill. We believe Alaska's present income tax law as it applied to the oil and gas industry in Alaska is equitable and provides uniformity with other industries and most of the other States that levy income taxes. A departure from this uniformity could result in overlapping taxation by the States.

Mr. President, it is unusual for a large multinational corporation like Exxon to speak with favor about any tax. Yet clearly Exxon endorses the unitary tax in Alaska.

No case has been made to justify the Federal Government's intervening by way of article 9(4) of the U.K. Treaty [p. 18418] to prohibit Alaska, Oregon, and California from using a unitary tax method. No case has been made to prohibit its use by the 42 other States and the District of Columbia that have adopted variations of this formula.

Why should the States be forced by the Federal Government to adopt an arm's-length method of assessing the proper allocation of costs and determination of profits between subsidiaries and parent corporations that operate on a global scale?

In the course of the investigations that I conducted of multinational corporations we heard much testimony about the unsatisfactory character of that method, about the inability of the Federal Government to accurately allocate costs or determine where profits lay within such enormous corporations. If the Federal Government cannot do it with all of the expert advice available to the Internal Revenue Service, with all of the accountants at the disposal of our national Government, then how can we expect State governments, limited in their resources, limited in their accounting and bookkeeping capacity, to successfully invoke an arm's-length method to determine what part of the profit of a great corporation can be attributed to that State?

What business is it of the Federal Government to intervene through an agreement that has been negotiated with the United Kingdom and say to the 50 States:

You cannot adopt a unitary method because Washington and London have agreed that British-owned corporations may not be taxed by the States in this fashion?

It has never been done before.

This is a mischievous extension of the treaty power to fashion internal tax policy. Again and again Congress has been asked to establish a national policy limiting State governments in their method of taxing multinational corporations. Again and again Congress has refused. Yet it was Congress that was supposed to decide such matters.

Now we propose to override a refusal by Congress to restrict State governments by imposing that restriction in the form of article 9, section 4 of the pending treaty with the United Kingdom.

We will regret doing it as time passes and we find that the treaty power is again and again invoked to circumvent both the Congress and the States.

For these reasons, Mr. President, I hope very much that the Senate will see fit to strike article 9, section 4 from the treaty by way of my reservation to the resolution of ratification. That vote, I understand, will come tomorrow, and I would hope that if Members of the Senate carefully study the issues at stake here the proposed reservation will be adopted.

Mr. President, I reserve the remainder of my time.

The PRESIDING OFFICER. The Senator from New York.

Mr. JAVITS. Mr. President, I yield myself 15 minutes.

The description of what is taking place here is very analogous to the blind man and the elephant. The particular provision to which my colleague refers is but a part of a larger whole which is of great interest and of great importance to the United States in terms of Federal income tax revenue, and to the business community of the United States.

It has been pointed out, I think quite properly, that the concern about article 9(4) emanates from three States, the largest being California. If I can read the official position of the State of California to the Senate we would put in sharp focus what I meant when I said we have here a presentation of the blind man and the elephant, the blind man who could touch but one infinitesimal part of the elephant and not understand its whole.

We have a declaration, in telegram form, from the Governor of California and one of its Senators, which is found at page 399 of the record of the Foreign Relations Committee hearings on the treaty, and which reads as follows:

Hon. John J. Sparkman
U.S. Senate, Dirksen Senate Office Building, Washington, D.C.

DEAR SENATOR SPARKMAN: Since our separate letters to you on July 21, 1976, and April 1, 1977, regarding the United States-United Kingdom Tax Treaty, we have been informed that the revenue loss to California will be far less than $100 million to $125 million originally indicated. The direct loss of tax revenue to California resulting from the exclusion of the foreign operations of foreign parent corporations from the unitary method of taxation may be 15 or 20 million dollars.

Furthermore, it is the judgment of California's Business and Transportation Secretary, Richard Silberman, and the State Director of Finance, Roy Bell, that ratification of the treaty will have a positive net economic impact on California.

Secretary of the Treasury Blumenthal has specifically requested our support for ratification of the treaty and has emphasized that the Carter Administration believes it to be in the international interest.

In light of the above, it is our judgment that it is in the best interest of California as well as the nation that the United States-United Kingdom Tax Treaty be ratified.

Sincerely,

EDMUND G. BROWN, JR.,
Governor.

ALAN CRANSTON,
U.S. Senate.

I understand, that, Senator HAYAKAWA will speak tomorrow, to the same effect, having already manifested in his testimony before the committee his support for the committee's position.

Now, Mr. President, I opened with Governor Brown's letter for this reason: I yield to no one in my respect and regard for my friend from Idaho, who has proposed this particular reservation, but I urge the Senate to look at the whole treaty, before we get diverted on to this particular proposition, which will have, in my judgment — and, incidentally, this is Secretary Blumenthal's judgment as well, not just mine — the effect of killing off this treaty.

The fact is, Mr. President, that this particular treaty was negotiated with the British at a time which was extremely favorable to us, a time when Britain was in considerable economic difficulty and was reaching out for ways in which she could improve her situation.

This treaty was attractive to England because she was smarting under serious economic difficulties, but we were smarting very much more. Mr. President, because there were hundreds of millions of dollars in taxable U.S. income which were tied up in British, and which could not be paid to American investors, both portfolio and capital investors, because of British law, which discriminated against American investors by not providing them with refunds of the Advance Corporation Tax, which British investors were getting.

These dividends, if you were a United Kingdom citizen, were rebatable under their unitary apportionment tax system, but they were not rebatable to U.S. citizens, and so American investors were completely hung up beginning in 1973, when that law passed, to the tune of hundreds of millions of dollars.

The purpose of this treaty was to loosen up that money, and the treaty will result, if ratified this year, in cumulative refunds of approximately $375 million, to be repatriated to the United States, with subsequent annual refunds totaling $85 million — an annual tax benefit to the U.S. Treasury.

Also, Mr. President, and I now cite Secretary Blumenthal:

The proposed treaty is also very significant from the standpoint of international tax relations. It is the first treaty ever to reconcile successfully a classical system of corporate taxation such as that

of the United States with the type of integrated system currently in place in many developed countries. Without such a reconciliation, United States investors encounter discriminatory taxation in countries having such integrated tax systems. We are hopeful that the provisions in the proposed treaty dealing with this discrimination will serve as a model in our current treaty negotiations with France, Germany, Canada, and other countries that have integrated systems similar to that of the United Kingdom.

Coming now to the particular matter about which Senator CHURCH has been debating today: this article represents a concession which we have made to the United Kingdom. It is one of the very few concessions made in this treaty; and the whole cost of the concession, in terms of State revenue, Mr. President, is estimated at $25 million for the three States which are referred to — and, by the way, Idaho has not even installed this system; it may wish to, but it has not done so. Of the three States we referred to, the potential taxation for California itself amounts to only $15 million or $20 million. Yet we are asked to kill off the whole treaty for that reason.

Let me tell the Senate why I say we are asked to kill off the whole treaty for that reason. Here is what Secretary Blumenthal said in his letter of May 2, 1978. I ask unanimous consent that the entire letter be printed in the RECORD at this point.

There being no objection, the letter was ordered to be printed in the RECORD, as follows:

[p. 18419] THE SECRETARY OF THE TREASURY,
Washington, May 2, 1978.

HON. JACOB JAVITS,
U.S. Senate, Washington, D.C.

Dear Jack: A proposed new income tax treaty between the United States and the United Kingdom will soon be before the Senate. The Treasury supports this treaty, and I am writing to urge that you vote for its ratification.

The proposed treaty is extremely advantageous to the United States. One of its most important provisions obligates the United Kingdom to make substantial refunds of taxes (estimated to

amount to some $375,000,000 for the retroactive period from 1973 to 1978, and about $85,000,000 each year thereafter) to American investors in United Kingdom corporations. A transfer of funds of this magnitude from a foreign Treasury to United States investors should help both our balance of payments and the value of the dollar in foreign currency markets.

The proposed treaty is also very signifcant from the standpoint of international tax relations. It is the first treaty ever to reconcile successfully a classical system of corporate taxation such as that of the United States with the type of integrated system currently in place in many developed countries. Without such a reconciliation, United States investors encounter discriminatory taxation in countries having such integrated tax systems. We are hopeful that the provisions in the proposed treaty dealing with the discrimination will serve as a model in our current treaty negotiations with France, Germany, Canada, and other countries that have integrated systems similar to that of the United Kingdom.

Some persons have objected to Article 9(4) of the proposed treaty, which limits the application of the so-called unitary method of taxation. The unitary method is a means of allocating the income of a multi-jurisdictional business among the relevant taxing jurisdictions, through the use of a formula. The method is not employed by the federal government but is employed in various forms by certain states. I believe that Article 9(4) has been the subject of considerable misunderstanding.

The Article prevents the application of the unitary method with respect to the income of foreign corporations controlled by United Kingdom interests. We understand that only three states — California, Alaska and Oregon — extend the unitary concept to such income, that is, income of foreign corporations controlled by foreigners. The inclusion of Article 9(4) in the treaty was strongly urged by the British on the ground that the unitary method as applied to United Kingdom corporate groups imposes excessive recordkeeping and reporting burdens and often results in state taxation of income having no connection with the taxing state, thus violating a basic international tax principle. The article will have the salutary effect of limiting a system of taxation which

foreign investors often find burdensome, unfair, and a disincentive to investment in this country.

From the standpoint of the United States, Article 9(4) represents a narrowly drawn and relatively minor concession, by any measure, in relation to the overall balance of benefits in the treaty. The treaty makes clear that states are not in any way precluded from using the arm's length method of controlling prices in transactions between related parties to ensure that a multi-jurisdiction business does not arbitrarily shift income from one tax jurisdiction to another. The arm's length method is employed by the taxing government, and the transfer price information developed in federal audits can be made available to state tax authorities. Thus, the treaty restriction on unitary taxation should not have a serious impact on tax revenues, if indeed it has any adverse impact at all. Moreover, it is reasonable to conclude that other aspects of the treaty, especially the provisions requiring refunds of United Kingdom taxes, will tend to increase state revenues.

It would be extremely unfortunate, in my view, if the Senate were to enter a reservation on Article 9(4) or otherwise fail to ratify the proposed United Kingdom treaty as it stands. A reservation would require that the treaty be sent back to Parliament for reconsideration. After a review of the new balance of concessions in the revised treaty, Parliament might enter reservations of its own, which would be costly to U.S. investors, the Treasury, and the states. Moreover, further delay in achieving ratification could do considerable damage to our efforts to reach satisfactory international tax agreements with other countries.

For these reasons I respectfully urge that you vote for Senate ratification of the proposed treaty.

Sincerely,

W. MICHAEL BLUMENTHAL

Mr. JAVITS. I would like to repeat particularly these closing sentences:

It would be extremely unfortunate, in my view, if the Senate were to enter a reservation on Article 9(4) or otherwise fail to ratify the proposed United Kingdom treaty as it stands. A reservation would require that the treaty be sent back to Parliament for

reconsideration. After a review of the new balance of concessions in the revised treaty, Parliament might enter reservations of its own, which would be costly to U.S. investors, the Treasury, and the states. Moreover, further delay in achieving ratification could do considerable damage to our efforts to reach satisfactory international tax agreements with other countries.

For these reasons I respectfully urge that you vote for Senate ratification of the proposed treaty.

Now, Mr. President, to go on: It has also been said in the arguments that this is an unprecedented restriction upon State authority. But, Mr. President, this is not breaking new ground at all. There are many tax treaties to which the United States is a party, in which the States are prohibited from imposing discriminatory taxation on foreign residents and foreign companies. That is almost universal in tax treaties, and that is a very important restriction on States.

Also, Mr. President, there are treaties like the Vienna Convention which limit the application of State and local taxes respecting foreign diplomatic personnel. Again, to a place like New York, that is a tremendous restriction. We have them all. But nonetheless, Mr. President, we have to yield to the national will.

In addition, Mr. President, there is an alternative to this unitary method of taxation as far as the States are concerned. Most of the States have what is called the arm's-length system, which is considered to be, by our own Treasury and by all of these States, a very much fairer way of assessing taxation.

Indeed, the reason that the United Kingdom insisted on the exclusion of this unitary tax method is because it is basically unfair. It has no relation whatever to property owned or business done. It simply represents an attempt to apportion tax on the global operations of a particular foreign enterprise which happens in the case of this treaty to be a United Kingdom enterprise. Hence they rebelled against it. The arm's-length system on the other hand is based upon business done and property owned in the United States.

Now, the unitary tax system in some form may be applied in many States, but these States limit the application to the domestic operations of foreign corporations. If a foreign corporation does business in 40-odd States of the United States, certainly in that case you can make an apportionment based on the unitary approach for the operation of the corporation in the States; there is nothing unfair about that. But in worldwide operations with no relation to U.S. business, I think the United Kingdom is absolutely right; this should be prevented. And, as I say, the application of the unitary system in the global operations of non-U.S. corporations has been done only by very few States, and involves very modest amounts of money.

The critical question is therefore the following: After all this time and with all of the benefits accruing from this treaty in terms of the business operations of the United States, the increased revenues to the U.S. Treasury and in terms of increased American investment in other developed countries with comparable tax systems to that of the United Kingdom, shall we, in effect dump this treaty for this particular article, considering the relationship which it represents to the total proposition?

The Foreign Relations Committee voted 10 to 5 against recommending a reservation based upon exactly these arguments which were made by Senator CHURCH and myself; and I respectfully submit that this was the right decision.

Just to finish, and then I will yield to the majority leader. I would like to explain the reason for my active participation in this procedure. Why am I involved? Why have I suddenly taken up this matter and become a manager of a treaty?

The reason is, Mr. President, that I believe that the future of this world is in the fair opportunity available to Americans to invest everywhere and to foreigners to invest here. The development and aggrandizement of that opportunity represents the capacity of the capitalist system to triumph over the Communist system which is so material to the facilitation of world trade, so that we do not have the parochialism destroying the free world today.

So my interest is in the precedent, and the results that will automatically accrue.

Mr. President, I yield to the majority leader.

Mr. ROBERT C. BYRD. I yield to the Senator from Louisiana.

* * *

[p. 18421] Mr. CHURCH. Mr. President, let there be no misunderstanding about the fact that the particular Article 9(4) in the pending treaty is unprecedented. The Senator from New York says we already have tax treaties which provide that foreign diplomats in New York City will not be subject to State or local taxes. Therefore, article 9(4) is not unprecedented.

Well, that is true, Mr. President. We also have provisions in tax treaties which provide that State governments may not discriminate. That is to say, they may not tax a foreign-owned corporation doing business within that State at a higher rate than they would tax a home-owned corporation.

These nondiscriminatory provisions or these provisions that relate to the traditional immunity that is granted to foreign diplomats in this country are of an entirely different character, dimension, and scale from what will be wrought by the inclusion of article 9, section 4, in the pending treaty, because never before have we gone beyond these nondiscriminatory provisions in tax treaties to say to State legislatures that they may not choose a given method for imposing taxes on multinational corporations doing business within their boundaries. Never before have we undertaken to interfere with what has been the right of the States to determine tax policy within those States.

I do not ask Members of the Senate to take my word for it.

When the State Department sent this treaty to the President, the letter of submittal, included in executive K as part of the basic treaty documents and forwarded by the President to the Foreign

Relations Committee, acknowledges that article 9(4) is unprecedented with these words:

This provision represents the first attempt to bind State and local taxing authorities by a substantive provision of the treaty.

Furthermore, we have the statement of the staff of Joint Tax Committee prepared for the use of the Committee on Foreign Relations on this same question. This is what they have to say about the provision:

The proposed treaty contains a new provision, Article 9(4), not found in other United States tax treaties or in the OECD Model Tax Treaty, which places limitations on the combined reporting method used by several States of the United States to determine the taxable income which corporations derive from sources within the State.

So that should settle the argument as to whether or not this article is unprecedented. Clearly, it is.

In his argument, the distinguished senior Senator from New York said that the revenue losses to the State of California would not be very large if we were to ratify this provision and include it in the treaty. He said, as I recall, that the losses might be as little as $20 million or $25 million.

Well, Mr. President, that is subject to considerable dispute in California. The Governor is engaged in lively argument with both the State Comptroller and the Franchise Tax Board in California, and they take a vey different view from that currently expressed by the Governor, who, incidentally, a few months ago opposed this article and then reserved his ground. But neither the California Comptroller nor the California Franchise Tax Board reversed their ground. They have testified strongly before the Senate Foreign Relations Committee against retention of this provision in the treaty, on the ground, among other reasons, that it would occasion a very serious revenue loss to the State of California. The Tax Commission places their estimate of the loss at $125 million.

What about Alaska, Mr. President? I know that the distinguished Senator from Alaska, who will speak here soon, will cover this subject fully. But I do not think it inappropriate to include at

this point in my argument the estimate of Sterling Gallagher, commissioner, Department of Revenue of the State of Alaska, who appeared as a witness at the time of the hearings. Senators will find on page 146 of the hearings his statement to the effect that this treaty will cost the State of Alaska in 1980 around $50 million.

For a State the size of Alaska, that is a great deal of revenue, indeed.

So I reject the contention of the Senator from New York that this will have minimal impact upon the States. It is not borne out by the weight of the testimony before the committee.

My good friend, the able Senator from New York, who is very knowledgeable in tax and financial matters, has suggested to us that we ought not look at article 9, section 4 alone, that this, after all, is but one piece in a great mosaic, which is the treaty taken as a whole.

He makes the case for the treaty taken as a whole, suggesting that somehow if we were to reserve our consent on article 9, section 4, the whole treaty would collapse.

Mr. President, I cannot accept that argument. I do not think that there is a basis for it in the RECORD. Rather, from what I know of the negotiations, I believe that had we not offered article 9(4) as a concession, we still could have secured the British tax reductions for the American corporations as contained in the treaty.

One need only peruse the treaty to realize the magnitude of our other concessions, which should have obviated the need to concede article 9(4).

For example, we have agreed to exempt all British insurance companies from paying the customary insurance excise tax. Because 50 percent of foreign insurance that insures U.S. risks is owned by British investors, this tax exemption will result in major revenue losses to the U.S. Treasury.

We have also agreed to offer foreign income tax credits to the oil companies for the special taxes that they pay to Britain on North Sea oil activities — contrary to a ruling by the Internal Revenue Service in 1975 — with a potential cost to the U.S.

Government of some $300 milion to $600 million annually by 1983.

We also create by this treaty a shipping haven in the United Kingdom, and we make Britain's advance corporation tax creditable, dollar for dollar, against the U.S. tax, again at an enormous potential cost to our Treasury.

Finally, I would like to point out that the Dutch have recently negotiated a tax treaty with Britain that provides for a tax break to Dutch corporations in Britain, but does not require any change in the Dutch taxation of British corporations similar to article 9(4).

In sum, it appears that the American concession was unnecessary and, in fact, should not have been offered in the first place.

So I do not think we can take it as an article of faith that if we strike this particular provision from the treaty all the work entailed in this negotiation will collapse and the treaty itself will fall.

[p. 18422] Finally, Mr. President, let me emphasize that the benefits in this treaty do not abound to the Government of the United States, nor to the American people as a whole. The benefits we derive from this treaty are directed toward the stockholders of American-owned companies doing business in Great Britain — a very narrow group of well-to-do people. They are the ones for whom the treaty has been crafted. They are the ones who will benefit from its provisions.

I know that multinational corporations want this treaty. I know the difficulty of surmounting their combined influence. It rarely happens. Whether or not the Senate chooses to adopt this reservation, I suggest that it is in the interests of the ordinary people of this country and it is in the interests of the Treasury of the United Staes.

Furthermore, the adoption of this reservation would send a clear signal to the Treasury Department and to the State Department that it is the Congress of the United States that should determine tax policy for this country and that it is regarded as an improper use of the treaty power to attempt to force upon this

country a change in tax policy that Congress, itself, consistently has refused to accept.

Once we begin to use tax treaties for the purpose of legislating internal tax law, once we begin to use agreements with foreign governments as a device for limiting the power of our own State legislatures to adopt tax formulas that are applicable to businesses in their own jurisdictions, we have set ourselves upon a course that we will live to regret.

I can fully understand why so many State governments are calling upon us to reject this provision of the pending treaty, for they know how much is at stake for them if we fail to do so.

For these reasons, Mr. President, I hope that the Senate will see fit to reserve article 9(4) from the consent otherwise given by the resolution of ratification.

Mr. President, I reserve the remainder of my time, and I yield to the Senator from Massachusetts such time as he may require.

Mr. KENNEDY, Mr. President, I give my strong support to the proposed reservation to article 9(4) of the pending tax treaty with the United Kingdom.

The provisions of article 9(4) would prohibit the States of the United States from applying the so-called unitary method of accounting in taxing the income of multinational corporations based in the United Kingdom.

One of the most difficult areas of tax policy is the proper method for allocating the taxable income of multistate and multinational businesses among the various jurisdictions with which the businesses have contacts. In recent years, a number of States have recognized the simplicity and workability of the unitary accounting method, and have adopted it for allocating the worldwide income of multinational corporations to their jurisdictions for the purposes of applying State tax laws.

Under a common version of the unitary accounting method, a proportion of a firm's worldwide income is allocated to a State according to a three-factor formula based on the firm's property, payroll and sales within the State. In part, this procedure has been

adopted by the States in response to devious efforts by multinational corporations to manipulate the income and transactions of their U.S. subsidiaries, in order to remove as much of that income as possible from the reach of State tax laws.

Some claim that it is possible to pierce these corporate shells, to analyze the complex "transfer pricing" and other subtle arrangements by which foreign corporations try to slip beyond State tax commissioners, and to arrive at a realistic definition of multinational profits that can legitimately be taxed by the States.

But few, if any, State tax officials believe that this alternative can work in practice. They have neither the resources nor the time to go through the myriad transactions and structures of the multinational pyramid. It stretches the imagination beyond the breaking point to suggest that the U.S. Treasury Department can fill the gap, by providing the "technical assistance" that State tax offices need to perform this difficult accounting surgery.

Yet article 9(4) of the pending treaty, by outlawing the unitary method of accounting, would relegate the States to precisely this burdensome effort to determine the amounts of income derived by multinational corporations from activities in their States.

In effect, the treaty would nullify, for all practical purposes, the reasonable efforts of States to apply their tax laws legitimately to the income of multinational corporations operating within their borders.

At this time of growing national concern over rising taxes, and widespread efforts in many States, fueled by Proposition 13 in California, to relieve the burden of property taxes on local citizens, it is unfair for the Federal Government to cripple the States in their effort to find reasonable alternative sources of income.

Article 9(4) would have the entirely undesirable practical consequence of allowing multinational corporations to lurk in foreign tax havens, hiding behind foreign subsidiaries and corporate shells, sucking income and profits out of the United States, and then thumbing their noses at State tax commissioners in every State. In effect, the treaty provision would create modern

counterparts of the old foreign gambling ships, plying their trade outside the 3-mile limit, thwarting all the law enforcement efforts of local sheriffs.

The unitary method of accounting has widespread support among tax experts as a simple, efficient, and equitable method of allocating multijurisdiction income for the purposes of State and local taxation. It is a method that is also widely used within the United States for apportioning the income of U.S. firms engaged in business activities in more than one State.

As recently as a week ago today, the Supreme Court of the United States upheld an Iowa statute prescribing — not the preferred three-factor formula — but a more limited, single-factor formula based only on sales within the State. It was argued by corporations subject to the tax that Iowa was using a discriminatory formula that concentrated too much out-of-State corporate income in Iowa, and subjected such corporations to double taxation. But the Supreme Court rejected the claim in Moorman Mfg. Co. against Blair, decided on June 15 by a 6 to 3 majority. According to the Court, the single-factor formula based on sales was not so arbitrary as to be unconstitutional. The out-of-State corporation had failed to prove that the income attributed to Iowa for purposes of Iowa taxation under the formula was "out of all reasonable proportion of the business transacted" in Iowa.

The same principle applies to the pending treaty. Use of the much fairer three-factor formula primarily at issue here should not arbitrarily be denied to the States in their efforts to reach a reasonable allocation of multinational corporate income to activities within their borders.

If the unitary method of accounting produces arbitrary results in some cases, the answer is to change the formula, not to throw out the baby with the bathwater by barring all unitary formulas. Yet this is the approach the Treasury negotiators have taken in bringing article 9(4) to the Senate for ratification.

Mr. President, I would like to mention here a little bit about what we have found in the Senate Antitrust Subcommittee about the accounting procedures by at least one major oil company, the Exxon Co.

It should come as no surprise that the major international oil companies are strong supporters of the proposed tax treaty with the United Kingdom. They obviously stand to benefit from a number of the provisions. But what is remarkable is the enthusiasm with which they have embraced the provisions prohibiting the use of the unitary method of taxing multinational corporations. This position is so obviously inconsistent with what we have heard from the industry in other contexts that it deserves careful examination.

The issue arises because a multinational corporation can artificially reduce its tax burden in a particular State by simply selling its products to a subsidiary in that State at inflated prices. As a result the subsidiary will appear to earn little or no profit in the State, thereby reducing its State tax burden.

This transaction, of course, does not in any way affect the corporation's real profits, since the sale to the State subsidiary was only an intra-corporate transfer, not a real sale.

In an effort to deal with this problem, a number of States have decided that where a corporation functions as a unit, each subsidiary being dependent upon the others, the State should ignore transfer payments and compute its taxes based upon its fair share of the overall corporate revenue. This approach obviously depends upon the unitary nature of the corporation involved. A [p. 18423] corporation that has hamburger stands in State A and a car rental operation in State B is clearly not unitary. It would be unfair to allow State A to use its hamburger connection to tax the car rental profits earned in State B.

What is remarkable about the present situation is that the oil industry, both in State tax proceedings and with respect to this treaty, rejects the unitary concept and strongly endorses the use of transfer payments for computing tax liability. But the crocodile tears now being shed by the industry are clearly at variance with other statements by the industry in other circumstances approving the unitary method.

In 1976, Senator Philip A. Hart, chairman of the Senate Antitrust Subcommittee, called to the Senate's attention certain State Tax Commission litigation involving Exxon. At that time,

vertical divestiture was the issue. Texaco was running television commercials showing how the parts of an integrated oil company fit together like pieces of a puzzle. Mobil ran cartoons of a man hacking up a garden hose to demonstrate divestiture. Congress was deluged with material extolling the benefits of vertical integration and warning of the dire consequences that would come if the intricate system of integration were taken apart. The industry referred to divestiture as dismenberment, conjuring up an image of hacked-off limbs gushing oil, if not blood.

In the midst of this furor, Senator Hart uncovered the fact that Exxon was singing a different tune in Wisconsin at the time Exxon was opposing the State of Wisconsin's effort to use the unitary tax method, on the ground that Exxon was not — I repeat not — a unitary corporation.

Exxon's position was no mere technical tax argument. Completely inconsistent with their divestiture argument, they set out in Wisconsin to demonstrate that, in fact, their corporation was not at all the highly integrated and interdependent organization we had been hearing so much about in Washington. Rather, they had become a group of loosely affiliated organizations that could quite easily be separated with no serious economic consequences.

What is particularly relevant to the present treaty is the fact that, when divestiture was the issue, Exxon actually asserted to the Antitrust Subcommittee that there was no way that the "arm's-length transaction" standard could be used to separate profit and loss figures for its divisions and subsidiaries. Logically, of course, it should be impossible to compute State taxes for each division. The only possible way to compute such taxes should be on a unitary basis.

In December 1975, Senator Hart wrote to a number of major oil companies, incluing Exxon, and requested certain financial data. The letter contained an "Item 5" which asked for "profit and loss" statements and balance sheets, audited or unaudited, separately covering production, transportation, refinances and marketing."

Mr. A. L. Monroe, Exxon's comptroller, replied to Senator Hart's letter, saying:

> ... Exxon Corporation's financial records are not maintained on a functional or segment basis similar to those categories set forth in your Item 5.

Mr. Monroe elaborated:

> As for further statements of revenue and expenditure data directly attributable to each of the above-mentioned groupings (crude production, refining, marketing and transportation), our corporate records are not maintained in that manner, nor do our independent public accounts prepare such allocations.
>
> The petroleum business is unitary in nature. The most meaningful segmentation of our operations is the "upstream", "downstream" segmentation. Further breakdowns require many allocations and assumptions, which could lead to erroneous comparisons of data between various companies and hence erroneous conclusions.

As Senator Hart pointed out, Exxon's position at that time was inconsistent on two important points with the corporation's position before the State tax authorities.

First, Exxon unequivocally told the Senate that "the petroleum business is unitary in nature." Yet, in the Wisconsin tax proceeding, Exxon's counsel stated:

> Our evidence will show that none of [Exxon's] functional departments, are integral parts of a unitary business; rather each function is independent and not unitary to, or an integral part of, any other function.

Second, Exxon's letter denied the existence of profit and loss statements for separate functions. But in tax litigation in South Carolina, Exxon had filed a complaint which said:

> Each of these functions is managed and accounted for on a functional operating basis. Each is a segment of [Exxon's] total corporate enterprise, but each has its own accounting, budgeting and forecasting, its own management and staff, its own profit center, its own investment center, its own physical facilities, etc.

The profit or loss of each function is separately and accurately computed.

These are not statements taken out of context. They were central to Exxon's case in each proceeding. The statements of Exxon's counsel elaborated on these arguments at great length.

Mr. President, the multinational corporations can not have it both ways. The Senate is entitled to take their opportunistic arguments against this reservation to the tax treaty with a very large grain of salt. Depending on this issue, they whisper an argument into the Senate's divestiture ear and a squarely contradictory argument into the Senate's taxation and treaty ear.

In my view, the Exxon materials vividly demonstrate the shallowness and hypocrisy of the arguments made in favor of article 914 of the treaty. The Senate should reject those arguments, and vote in favor of the pending reservation.

Mr. President, even apart from the lack of merits in the substance of section 9(4), the provision is also vulnerable to serious objections because of the procedure by which it was negotiated.

The desirable method of congressional action in this complex area of taxation should be the route of legislation, rather than treaty. Serious considerations of Federal-State relations are involved here — considerations that are easily slighted by the treaty negotiation and ratification procedure. It would be preferable, therefore, to deal with the issue by legislation, so that the tax committees of the House and Senate may also consider the problem and recommend solutions, and so that the States may have the opportunity they deserve within our Federal system to protect their basic rights in this sensitive fiscal area.

A wiser approach would have been for the administration to submit general recommendations for legislation on this subject. These recommendations would be the subject of discussion and debate in the House and Senate and I am confident that Congress would reach a prompt resolution of these questions in a way that both protects the rights of State governments and deals fairly with multinational corporations.

It is hardly a satisfactory approach for the Senate alone to attempt to make a preliminary and unprecedented resolution of this sensitive issue of States' rights in the context of a treaty.

Finally, the administration asks us — whatever our reasons for opposing the substance and procedure with respect to section 9(4) — to swallow our objections, for fear that if a reservation is adopted, the treaty may be rejected by the British Parliament. I welcome the benefits negotiated for the United States, and particularly for American investors, in other articles of the treaty. But I find the administration's desire to promote U.S. investment in Britain curious, to say the least, in light of our widely shared concern over the sluggish levels of investment here at home.

In any event, I seriously doubt that any responsible action we take in adopting a reservation to article 9(4) will jeopardize the treaty as a whole. There are obvious compromises that can be negotiated to avoid any arbitrary application of the unitary method of accounting to British corporations operating in American States, without taking the drastic and unnecessary step of prohibiting the method altogether.

This treaty itself, signed in London in 1975, has already been the subject of amendment by an exchange of notes and two protocols. It strains credulity for the administration to maintain that another protocol could not be easily arranged with Britain to repair the damage that article 9(4) would do to the States and our Federal system, while fully protecting the rights of British multinational corporations to conduct their business in the United States, free from unjust State laws or overly aggressive State tax commissioners.

The reservation that has been proposed to article 9(4) will not jeopardize the treaty, and it deserves to be supported by the Senate.

Mr. President, I reserve the remainder of my time.

Mr. PELL. Mr. President, I yield such time as he desires to the Senator from Iowa.

The PRESIDING OFFICER. The Senator from Iowa.

[p. 18424] Mr. CLARK. I thank the Senator very much.

Mr. President, I agree with the remarks of the Senators from Idaho and Massachusetts.

I, too, am extremely concerned about the propriety of placing such unprecedented limits on taxing, particularly State taxing authority through the vehicles of a tax treaty ratified by only one House of Congress. This constitutes little more than the IRS deciding, by fiat, what method of taxation the States may use. As far as I am concerned, this is a bad way to make tax policy. The issue should be addressed thoroughly by both the House of Representatives and the Senate and by their Ways and Means and Finance Committees, particularly.

Mr. President, I am especially troubled, because of the potential impact such a tax policy could have on farm States. Conservative estimates are that there is nearly $1 billion of foreign investment in U.S. farmland. Speculation is that the actual amount of foreign investment in farm properties is actually much higher than that.

One of the problems, of course, has been that records on foreign ownership of real estate are very sketchy. In fact, the Commerce Department has frankly admitted its inability to get a handle on foreign ownership of farmland.

Mr. President, I would ask unanimous consent to include at this point in my remarks several articles which appeared in Business Week and the Saturday Review which reflect the growing concern about the incidence of foreign ownership of U.S. farmland.

There being no objection, the material was ordered to be printed in the RECORD, as follows:

FOREIGN INVESTORS FLOCK TO U.S. FARMLANDS

Other investment markets have waned, but a cheap dollar, political instability overseas, and a long record of rising prices have made U.S. farmland the single hottest area for foreign investors. Although much of the foreign money is hard to trace, European Investment Research Center, a private consulting firm

based in Brussels, estimates that foreigners invested some $800 million in farmland last year. That would come to a startling 30% of all foreign direct investment in the U.S., according to the Commerce Dept. "What we are witnessing, says Kenneth R. Krause, a senior economist for the Agriculture Dept., "is the biggest, continuing wave of investment in American farmland since the turn of the century."

Nor does it look as if the trend is slowing down. Real estate advisers and brokers report that the buying interest, mostly from Western Europe but also from Latin America and Japan, is on the increase. The Arab oil states have apparently not yet been big investors. And marketing activity aimed at the potential investors is heating up. For example, Amrex Inc., a San Francisco-based real estate firm, is holding a meeting in Zurich next week to introduce buyers to sellers who represent as much as $750 million worth of U.S. farmland. Some observers warn that the industry is attracting its share of hucksterism as well. West German newspapers are being flooded with real estate advertisements, apparently from small U.S. brokers, that often offer only an anonymous post office box number for an address.

Predictably enough, U.S. farmers are irate, and the Agriculture Dept. and, most recently, Congress are growing increasingly concerned as well. Despite some recent softening, farmland prices are dramatically higher than they were a few years ago, and critics blame foreigners for much of the speculation. Also, many foreigners can take special tax breaks at home or through Caribbean subsidiaries that give them a significant advantage over domestic investors. Since last year's $24 billion in agricultural exports represented a major component of U.S. trade, Washington is especialy worried about increasing foreign control of U.S. farmland.

What also concerns the Agriculture Dept., as well as local farmers, is that the identity of the foreign purchasers is seldom known. Brokers and bankers steadfastly refuse to divulge names although they claim that most investors are wealthy individuals rather than corporations or investment groups. "We simply cannot get a handle on farmland," says a Commerce Dept. official,

"since ownership is disguised through the extensive use of trusts, partnerships, and corporations headquartered offshore."

SAFE INVESTMENT

Angry farmers and their allies in state capitals are trying to crack down on foreign investors by seeking registration of ultimate ownership and outright restrictions on foreign purchases. Kansas and Missouri have recently undertaken investigations of foreign investments. And the General Accounting Office is just beginning what will be the most sweeping probe. At the request of the Senate Agriculture Committee, the GAO will try to determine the extent and locations of foreign investment in farmland. "Once we get answers to these questions," says one committee aide, "we will decide what, if anything, we shall do about the trend."

The weakening dollar is only the latest of a number of reasons that foreigners are so attracted to farmland. Political instability in their home countries is pushing foreigners into U.S. investments. With stock and bond prices both down, real estate in general, and farmland in particular, is drawing foreign money. Many Europeans also believe that agricultural land is guaranteed to retain its value because they anticipate worldwide food shortages in the future. "American agriculture is nothing less than the safest investment around," says Ernst-Ludwig von Bulow, who specializes in U.S. real estate for a Hamburg-based investment fund, Lehndorff Vermogensverwaltung.

Present economic trends in U.S. agriculture have further whetted the foreigners' appetites. Land prices in recent months have fallen or softened just about everywhere, including the corn belt, but more noticeably in the Great Plains. As a result, the current annual rate of growth in farmland values has slowed to 5 percent or less from 17 percent a year ago. The slippage is due primarily to the continuing cost-price squeeze on American farmers, which is being worsened by depressed farm prices.

SUNBELT PURCHASES

But if land prices begin soaring again, it still makes sense for the Europeans to buy in, say real estate advisers. Farmland prices in Western Europe are roughly double the price of the same quality land in the U.S. — $3,000 an acre for prime farmland in West Germany and France vs. $1,500 an acre in the U.S. last year, according to Chicago's Northern Trust Co., which manages about 400 farms in 35 states.

While it is difficult to pinpoint where foreigners are buying most heavily, Jules A. Horn, director of the European Investment Research Center, says the so-called Sunbelt, which runs across the bottom third of the U.S., is attracting most of the money. He considers prices ranging between $600 to $1,000 an acre to be particularly attractive to Europeans. Until the present sag in the land price boom, Horn says, Europeans were far more interested in investing in California and the upper Midwest states such as Illinois and Wisconsin.

Hamburg-based Lehndorff has kept its investors out of the nation's richest farmland states, such as Iowa and Indiana, preferring to concentrate investments in Wisconsin, Missouri, and Arkansas. Singled out by von Bulow: farmland near the resort area of Lake Geneva, Wis., 60 miles from Chicago. "Lake Geneva is gradually expanding," he says, "which means that we may eventually be able to sell the land for construction." Jeffery White, head of Iowa Agronomics Inc., a farm management firm, adds that prices for Southern farmland are down drastically this year, and bargain hunters could come up with good buys in such states as Arkansas and Texas.

Meantime, real estate firms report that the growth in foreign business is providing a major fillip to their sales. Oppenheimer Industries Inc., Kansas City (Mo.)-based farm brokerage and management firm that operates a rural land portfolio comprising roughly 1 million acres of farm and ranch land, for example, reports that sales to foreign investors more than doubled in the past few years and now account for one-third of its annual volume. A typical Oppenheimer deal recently involved the purchase of a 1,215-acre soybean and corn farm for nearly

$1 million by a Western European. Two weeks ago, the company helped an Italian investor buy a 315-acre citrus grove for $1.4 million. San Francisco's Amrex says that of the approximately $100 million in agricultural deals that it arranged last year, half were with foreigners.

UNFAIR COMPETITION

What especially worries U.S. officials is the possible widespread use of foreign tax havens by farmland investors. Lionel S. Steinberg, director and former president of the California State Board of Food & Agriculture, finds it "totally objectionable" for foreign investors to buy California land through corporations headquartered in the Dutch Antilles, for example, which require payment of little or no income taxes. "This is unfair competition and a threat to bona fide family farming in the U.S.," says Steinberg, noting that tax-priviliged foreign investments make it difficult for prospective local buyers to compete.

NOTHING SINISTER

Understandably, brokerage firms, banks, and other intermediaries for foreigners are defensive about their activities. "Much of the paranoia concerning absentee ownership is due to poor communications," declares Reed J. Oppenheimer, vice-president for Oppenheimer's international activities. "These people are not the suspicious cloak-and-dagger people they are made out to be," he says.

Nevertheless, Oppenheimer concedes that foreigners "often purchase through a foreign corporate entity," which he adds is designed "to facilitate tax considerations in their own countries and here." But he argues vehemently that they are not driving up land prices, except possibly in what he describes as "a few isolated cases." "The well-heeled American farmers who can afford it are the ones who are driving up land prices," he maintains. And, Oppenheimer adds, only 3% of all farmland turns over each year.

What bothers dealers and managers of U.S. farmland is the new breed of promoters. "They are difficult to identify, but they

are all over Europe huckstering farmland. We assume most of them are American brokers trying to cash in on what they perceive to be a booming market in Europe" says the vice-president of a large Midwestern bank, who prefers not to be identified. "We worry about them because they claim buyers can make 10 percent, 15 percent, or more in net returns on their farm investments, and that is just ridiculous."

[p. 18425] "SOMETHING SOLID"

The bank official's point explains why large, U.S. institutional investors and corporations have generally shied away from investing in farmland on anything but a very modest scale. Bankers and agricultural economists generally agree that, depending on crops, productivity, and location, net cash returns on professionally managed farms rarely exceed 4 percent and are usually closer to 2 percent, without taking into account debt servicing and taxes. "Investors seeking fast or high gains should definitely not be in agriculture," cautions a vice-president for one of the big Chicago banks.

The European investors and their American intermediaries would be far happier if all the fuss died down. "The trend toward land investments by Europeans stems from the need for a safety factor, like gold," argues Horn of the European Investment Research Center. "These investments are not made for speculation, but forever." However, the controversy seems destined to continue simmering for the foreseeable future. Warns a staffer on the Senate Agriculture Committee which will review the GAO's probe: "We have no intention of dropping this issue until all the facts are in."

Invasion of the American Heartland
(By Christopher H. Stern)

A new breed of tenant farmer in the United States opens his eyes as the sun rises on his part of the world. What he sees, whether he is in Arkansas, Texas, or California, are acres and acres of the earth's highest-yield farmland. What he cannot see is the German industrialist in Dusseldorf, the Roman Clergyman on Lake Como, or the aging Argentinian banker, one of whom owns the farm he is about to work.

Lehndorff Vermogens Vermattung, a Hamburg-based holding company, owns 14,000 acres of choice midwestern farmland. M. Thomas Lardner, Lehndorff's general manager in the United States, says that non-resident "alien" investors want American farms. "The enthusiasm of Europeans for American farms is unbelievable."

A few foreign acquisitions have received publicity: Prince Lichtenstein's 10,000-acre farm in Texas's Red River area; the Busonis' 12,000-acre Norris farm in Illinois; the Metternich's 2,135 acres in Iowa; and the Japanese Kikamo farm in Wisconsin. However, viewed against the 340 million acres of American farmland, these purchases represent no more than a soybean in a bucket; but foreign investment in land is not limited to the acquisition of farmland. Overseas firms own 2 million acres of American forest land, hundreds of thousands of acres of coal and ranch lands, and a sizable amount of urban land. Farmland, however, is the property foreign investors are most interested in.

California is the hottest area of foreign investor activity. Amrex Corporation in San Francisco will sell $260 million worth of agricultural farms in 1977 to an assortment of Italians, Swiss, Belgians, West Germans, and Frenchmen. Says the corporation's exuberant president, Gerald Jackson, "Good farmland is selling as

fast as it's available. More than eighty percent of agricultural buyers are non-resident foreigners. We get a hundred inquiries a day from interested foreigners, and right now one of the world's biggest banks and one of the biggest investment houses are standing by with fifty million dollars of foreign capital to invest in farmland."

In New York City, Daniel Bodini, who speaks three languages, handles Eastdil Realty's foreign investors. Last year he sold 200,000 acres in the American West. This year he will sell more than twice that amount. But although other real estate companies and brokers also claim large sales to foreigners, the industry's consensus is that the big banks — particularly Northern Trust and Continental Illinois in Chicago — are doing the most spectacular business everywhere in the country.

"Foreign investors feel comfortable dealing with a bank," explains broker Davis Martin. "One hundred out of one hundred aliens who actually come looking for a U.S. farm begin by going to Northern Trust, and afterward eighty of them wander down the street to Continental." Though banks release no information, citing the fiduciary relationship they have with their clients, Northern Trust's 1976 annual report records 460,000 acres managed in 35 states. "Right now the banks couldn't be doing more farm business," says one successful Chicago broker, "and even if they've been in the business for twenty years, you can bet the overwhelming majority of their holdings are foreign because domestic owners have many better ways to manage their farms."

Davis Martin has good reason not to disparage the banks. In the Arkansas and Missouri river bottoms and in the Mississippi delta, he has handled 30 transactions worth $12 million. A competitor, Oppenheimer Industries, which sold $60 million in farms from 1974 through 1976 and will do $40 million in 1977 alone, has handled 15 to 20 farms in that region. "Foreign owners weren't too familiar with our temperate climate at first," drawls slow-talking, fast-closing broker Vardeman Moore, of Mississippi, "but they're warming to it real fast. There's a virtual land rush down here."

Foreign interest is also high in southwestern and midwestern states, but there are simply not enough large quality farms being put on the market. Henry S. Miller and Company and Interstable of Dallas each sold 15,000 acres to foreigners in 1975 and 1976. This year, they say that due to the lack of big farms they have made no sales. A few farms remain available, and foreign investors are snatching those up. Broker Fred Smith has handled 20,000 acres in the Red River area, and two-thirds of his business comes from foreign investors. San Antonio's Pleaz Naylor knows of 75,000 acres bought by foreigners in northwest Texas, but he agrees there are "a lotta lookers and little land." Complains one exasperated Chicago banker, "We can't begin to locate enough properties to please our foreign investors."

There are many reasons why foreign investors are buying American farms. "My clients are old rich families, disenchanted, nervous, or just scared out of their minds," notes Reed Oppenheimer of Oppenheimer Industries. "Many of them have had land in their families for a thousand years. They say, 'When Napoleon came, when the Prussians came, when the jewels were sold, we survived as a family because of the land.'" Brokers concur that foreigners want to salt away a place for themselves and their children and grandchildren because they fear Communism and consider America the strongest remaining bastion of free enterprise.

In a report to Congress, John Timmons, a professor of economics at Iowa State University, and Charles Curtiss, Distinguished Professor of Agriculture there, outlined the complex of incentives that are drawing foreign investors to U.S. farmland. They cited the hedge against inflation provided by the relative stability of U.S. prices and farming cost; the hope that investments in U.S. land will offer a refuge against land reform and political disorders abroad; the expectations of capital appreciation due to skyrocketing land values (witness the steady 15 to 35 percent annual rises since 1972); the tax advantages and natural advantage (access to food, materials, and farming technology) of investing in U.S. land; the fact that in terms of income and of capital appreciation, U.S. land safely balances investment portfolios; and the idea that — beyond the satisfaction, prestige, and psychic value of owning

farmland in the United States — such investment may give them control of strategic resources and provide them with a base of economic and political power within the country.

Though the incentives are well-known and heavy investment is apparent, scant information exists as to the magnitude or locations of foreign ownership. This is because land-related public records, traditionally kept at the county level, are not a practical device for disclosing who owns what and where. And since market advantage runs with secrecy, real estate people are unwilling to provide much information. By and large, brokers deal and do not tell. For example, Michael Hirsch, vice-president of Amnivest Corporation in New York City, admitted he had sold 25,000 acres of farmland to foreign investors — but quickly added that Amnivest was no longer interested in making farm acquisitions for aliens. Later, two independent brokers described being called in to an Amnivest because "the company heads are extremely anxious to locate farms for foreign investors."

The foreign investors themselves insist on anonymity. Some risk prison penalties for taking large sums of money out of their countries. Others fear that being publicly identified as persons of great wealth will make them targets for criminals and political zealots. A West Coast broker told of visiting an elite Spanish hunting club where the men had hunted together for 15 years — "yet not one of them knew that each of the others was my client. They just don't talk about it."

Silent purchases are facilitated by institutionalized investment vehicles. Much of the foreign money passes through either Credit Swisse or Deutsche Bank; through Bermuda, Bahamas, or Netherlands Antilles corporations if the source is Latin-American or European; or, if the source is Asian, through Hong Kong or Taiwan corporations. The American financial intermediaries used most often are Continental Illinois and Northern Trust. Transactions are rarely conducted principal to principal. In one deal for a 2,500-acre Kansas farm, an unnamed West German investor contacted a Canadian realty firm, which contacted a Wyoming broker, who contacted a Chicago bank, which employed a statewide Kansas broker, who in turn found a local broker. As Tom Martin, president of the Anchor Mutual Investment Fund, says of

the tangle of intermediaries, "Ten years ago a guy sitting in Frankfurt would've had trouble making a buy in total secrecy. Now it's a snap of the fingers."

American reaction to the unmonitored alien ownership of U.S. farmland varies. Businessmen stress the absolute prerogative of the free market economy. They point to the significance of creating a truly international world economic order, of maintaining an international cash flow, and of the tremendous value of American land investments abroad. "The internationalization of the world is as inevitable as it is necessary," intones broker Philip Dub, "and capital is the blood of the world's body, so it has to flow freely."

The real estate brokers argue that the hostile reaction of many farmers is xenophobic or, more bluntly, racist. After all, they note, a mere 3 percent of American farms change hands each year, and farmer-to-farmer sales account for 80 percent of all transactions. At this rate, how can foreigners ever own more than a sprinkling of American farms?

Farmers reply that foreign investors have collided head on with them and with their [p. 18426] farming communities. In the first place, they say, the unlimited capital resources of alien investors have been pitted against the farmer's instinct for expansion in what amounts to an unfair dollar dogfight. "I waited thirty-five years for my neighbor to die so I could buy his farm," says Iowa farmer Mike Degas. "When he did, it cost me an arm, a leg, and the shirt off my back."

The combined effect of this expansionist instinct and of agricultural technology has transformed the basic unit of rural communities from the small family-owned farm into the large family-owned farm. Today's corn and soybean operator, for instance, works an average of 1,000 acres, twice as much as he could cultivate 10 years ago. Farmers are very sensitive to the decline in the number of farms (from 4 million in 1960 to 2.8 million in 1976) and to the decrease in the farm population (from 15.6 million in 1960 to 8.9 million in 1975), for they fear a concentration of ownership. Ten years ago, the size of an average farm was 210 acres, in 1977 it is 310 acres. Any investor, therefore, who

threatens to further concentrate farm ownership is naturally viewed with hostility.

Foreign investors not only concentrate farm ownership but operation as well. Once a foreigner purchases a farm, an independent management service — Doane's of St. Louis, Oppenheimer's of Kansas City — or a farming subsidiary of a bank is hired. These managers then employ area farmers who, because they are already farming large land tracts, possess sophisticated farming techniques and expensive equipment. In the event that an alien's acquisition lies in a newly developed area where large-scale farming has not been practiced, an experienced farmer from a different county or state is brought in.

Local farmers are angered by the fact that absentee foreign owners are not civic-minded. Virginia farmer Ace Rudder notes that "foreigners force out people who were on the bank board and church board. These people supported local businesses while foreigners buy cheap from big dealers. In fact, the only small business growing around here is the farm brokers. And foreigners don't practice conservation, 'cause it's money they have to spend, and when it's not your living, people have short arms and deep pockets."

As to the charge of farmer racism, Harold Dodd, president of the Illinois Farmers Union, replies: "We are not against the foreign investor per se; we are against any large outside nonagricultural interests owning farmland. The biggest contributory factor to our being able to outproduce any country in the world [on the average, an American farmer feeds 57 people, a Soviet farmer feeds 7] is the structure of the family farming system, which has been a hallmark of our country since its inception."

Indeed, according to the U.S. Department of Agriculture, young families have been returning to the farm in sizable numbers. In the period from 1970 through 1975, the number of persons between the ages of sixteen and thirty-four who were self-employed in agriculture increased by about one-third over the preceding five-year period. Older farmers hope these young people will foster the regeneration of the smaller family farm, but they worry that the unlimited resources of foreigners will make it

impossible for young farmers to buy quality farmland at reasonable prices.

Politicians regard foreign interest in U.S. farmland in terms of politics at home and of America's position in the world. "To date," says Iowa congressman James Leach, "statistics indicate foreigners probably do not own incredible quantities of American farmland, but the trend pointing violently in that direction potentially endangers our nation." There is a general feeling that the emergence of an international economic order might promise greater world peace and prosperity, but as long as nations regard one another with the evil eye of self-interest, each — including the United States — had better guard its precious resources.

The "politics of food" aggravated by a desperate world food shortage is destined to become a critical international issue. American agriculture provides a balance-of-payments cushion for domestic politics in the United States as well as political leverage in international relations. The Soviet Union, Japan, and other industrial nations cannot reduce agricultural imports without dramatically affecting their food supply and their political stability. Thanks to the supremacy of the agricultural sector, the United States can always curtail imports in the event of foreign exchange difficulties. More than its thermonuclear power, America's agripower makes it a desirable ally and a force in the world.

Many states have statutes intended to prohibit or limit alien investment in farmland. At the federal level, there are three recently passed laws that are intended to facilitate the gathering of information about foreign investment. In the words of Senator Daniel Inouye (Dem.-Hawaii), "The lack of a national information base and of adequate data on agricultural land ownership have been recognized by the Congress . . . ." But as Washington tax lawyer Paul Toulouse comments wryly, "I can't see the ropes for the loopholes in any legislation concerning foreign land investment; it's just too easy to veil ownership with intermediaries, local trusts, or corporations."

It is not reassuring to hear lawmakers and others express concern about being blindfolded by a lack of information at a

policy crossroads. As Economic Research Service economist Gene Wunderlich says, "Land has sufficiently unique qualities to require separate attention in direct investment policy. America has a right, an immediate and possibly urgent right, to know who owns the land."

This is especially true in view of several ominous portents. Brokers admit they are beginning to receive numerous inquiries from farmers who want to sell to foreign investors because these buyers pay 40 percent down and in fact prefer to make all-cash purchases. (One retired broker in Arizona, a state that strictly prohibits alien ownership, says he might play a little less golf so he can respond to the inquiries he is getting each week.) Many real estate companies formerly unequipped to handle foreign investors are now feverishly preparing to enter the market. One particularly troubling sign is that in the past six months Amrex's Gerald Jackson, among others, has noted the first feelers from Middle Eastern holders of petro-chemical dollars seeking American farmland.

Even without new real estate brokers and an inflow of OPEC money, foreign interest in and acquisition of American farmland is like a luxury car accelerating powerfully and noiselessly. The incentives, the mechanisms, and the capacities for investment feed the momentum. In a few decades of harvesting, if no limit is assigned, foreign investment in U.S. farmland could eclipse American ownership. Then American agriculture, the nation's single greatest source of power, would pass from the hands of American citizens.

Mr. CLARK. Mr. President, the potential impact of this tax treaty, and others that may follow it, on agricultural States is twofold. First, if critics of the so-called arm's length method of taxation are correct, foreign investors in U.S. farmland will be able to escape significant amounts of taxation both here and abroad. This could give foreign investors a competitive tax advantage over potential domestic purchasers of land and possibly accelerate foreign and state investment here. In the process the price of land could be bid up and the degree of absentee ownership could rule.

Let me explain. As you know from the earlier remarks of my colleagues, Article 9(4) of the treaty precludes States from using the so-called unitary method of taxation on a combined reporting basis and relegating them instead to the arm's-length method of taxation.

It is argued that foreign corporations can escape significant taxation both here and abroad under the arm's-length method. For example, critics of this method point to businesses which establish corporate fronts in tax havens where they pay little or no taxes, and then juggle their books to make it appear that all of the corporation's income — including that growing out of activity in this country — was in fact earned abroad in the low tax jurisdiction. As a result of these tax savings, foreign corporations could find it relatively less expensive to buy and operate farmland here than would domestic purchasers in equivalent positions.

The second and related result which could flow from adoption of the tax policy contained in the tax treaty as written, is the erosion of agricultural States' income tax base. To the extent foreign corporations can escape State taxation under the arms-length method and to the extent foreign ownership of agricultural lands increases, the revenue impact on farm States could be significant.

Mr. President. I am not a tax expert and cannot say for a fact that preclusion of the unitary method of taxation will inevitably stimulate foreign investment in U.S. farmland or permit foreign corporations to escape taxation. I do not really think this is the time even to get into a debate about the relative merits of the unitary method or the arms-length method of taxation. My position is that where the questions as to possible impact are as substantial as they are here, a tax treaty, voted on by only the Senate, is a totally inappropriate vehicle to implement such a potentially harmful tax policy.

I urge my colleagues to join with me in supporting the reservation of article 9(4) of this treaty and opposing the treaty if article 9(4) is not reserved.

The PRESIDING OFFICER. Who yields time?

Mr. STEVENS. I would like to have some time on Senator CHURCH's time. I do not know who is controlling the time.

Mr. PELL. We are not going to use that time, so I will yield it on the proponents' side.

Mr. STEVENS. I would like to have 10 minutes.

Mr. JAVITS. Ten minutes.

Mr. STEVENS. Mr. President, for the past several months, I have, along with several other of my colleagues, urged that the Senate attach a reservation to article 9(4) of the United Kingdom-United States Treaty. At this time, I would like to outline some of the concerns that we have expressed with regard to this provision.

Article 9(4) would prohibit states from utilizing the unitary tax method in determining the tax liability of British [p. 18427] multinational corporations operating within their boundaries. The unitary method reflects the fact that all parts of a business enterprise, including its foreign affiliates, contribute to its profitability. If parts of a business are inter-related, such as drilling and marketing of a multinational oil company they are treated as a unit. The total income is apportioned to the States and countries according to the percentage of the company's business done in each. The percentage allocation is typically determined by means of a three-factor formula which includes property, payroll and sales. To determine its income attributable to a particular State, a corporation will construct as many fractions as there are factors, each representing the percentage of property, sales, and payroll in each State. The courts have recognized for years the fairness of the three-factor formula.

The alternative method of establishing tax liability is the arm's length method. The arm's length method accepts the corporate structure as presented by the company. If a foreign based company has subsidiaries in several States, the arm's length method assesses taxes based on the income in a particular State. For companies with foreign operations in several States, the shuttling of income to avoid taxes is hard to detect. To insure that income is properly distributed among the subsidiaries, IRS auditors would

have to go through all transactions, invoice by invoice, to determine if they were made at genuine "arm's length" prices. This method can be used to avoid taxation and thus cost the States millions of dollars annually. My State stands to potentially lose $50 million annually from the prohibition of the unitarty tax method. The importance of the State's abilities to distinguish foreign from U.S. income is vital, not only to protect State's revenues but also to prevent foreign firms from gaining an unwarranted tax advantage over U.S. firms in the same markets through their ability to shift U.S. income overseas or to States with lower tax rates. As multinational commerce grows, the ability of the States to deal with this problem becomes even more important. The arm's length approach creates a tax preference for foreign based firms and closes future options in the tax enforcement area.

Currently 23 States utilize the unitary tax method to some degree, and increasing numbers are adopting it as general policy. Many States find this approach favorable in its simplicity and its effectiveness in preventing tax avoidance. Even some corporations prefer its utilization, such as Exxon operating in Alaska. Whatever the deficiencies of the unitary approach, the fact that 23 States find it a desirable tool undercuts any justification for its prohibition. Let the States be the judge of which is the most appropriate method.

One of the major arguments against reservation is that it would jeopardize the entire treaty, one that could bring substantial revenues to the U.S. Treasury. According to a study conducted by the Joint Committee on Taxation, however, this is just not the case. The Treasury claims that the United States will greatly benefit from British concessions. In fact, article 9(4) is said to have been included in the treaty in return for article 10, which provides tax refunds for U.S. individuals and corporations that invest in the United Kingdom. It should be noted, however, that only one-third of the investors are individuals so mainly corporations would benefit. Also, foreign dividends are exempt from taxation, to some degree, from 19 States so this provision would not provide revenues to these States. Another provision, article 23, declares that the British petroleum revenue tax — PRT — will be creditable for U.S. oil companies. This means that U.S. companies drilling in the North Sea will be able to subtract their PRT straight from their U.S. tax bill, dollar for dollar. Absent the treaty, the IRS has indicated that the PRT be deductible. Article 23 would specifically make creditable a U.S. tax on profits derived from North Sea oil. At a time when congressional and administrative policy is to clamp down on the bestowal of tax credits for oil companies producing abroad, article 23 would establish these credits in a treaty where they would be beyond the reach of Congress to reverse. Further, once granted for oil companies, a chain of precedent would be set in motion and oil companies producing in places other than the North Sea would demand equal treatment.

Mr. President, I would like to bring the attention of the Senate to an editorial that was printed in last Sunday's Boston Globe. While the editorial brings to light several important concerns, I would like to mention the point it raises regarding States' rights.

Article 9(4) represents a serious limitation on State taxing power that is unprecedent in previous treaties and usurps the States' right to set up and enforce their own tax structures. This right is constitutionally empowered as a State function and allows for the establishment of an income tax that is not in violation of the commerce clause. Alexander Hamilton eloquently expressed this desirable role of the States in the Federalists Papers when he stated:

> The individual States should possess an independent and uncontrollable authority to raise their own revenues for the supply of their own wants . . . [T]hey would under the plan of the (Constitutional) convention, retain that authority in the most absolute and unqualified sense: and that an attempt on the part of the national government to abridge them in the exercise of it would be a violent assumption of power, unwarranted by any article or clause of the Constitution.

While I cannot argue that it is within the power of the Federal Government to limit that right, I suggest that a tax treaty is not the proper nor desirable medium for the exercise of this power. The States should be given the opportunity to participate in the

consideration of such restrictive action and both Houses of Congress should contribute to the dissolution of this issue.

I hope that each Member of this body will carefully review the implications of this provision and find it appropriate to support reservation of article 9(4). I hope every Senator to read this editorial from the Boston Globe and I ask unanimous consent that it be printed in the RECORD.

There being no objection the editorial was ordered to be printed in the Record as follows:

TAXING: STATE TAXATION

The advantages of lowering trade barriers and fostering international commerce have been much heralded. So too has the necessity of strengthening the ability of American states to meet the challenges within their borders. Those two objectives have come into contact in a treaty embodying a U.S.—United Kingdom tax agreement due to come before the Senate soon.

The treaty offers much to American investors — primarily multinationals — that invest in the United Kingdom including a $375 million tax refund for the years 1973-78 and about $85 million a year thereafter. The refunds would be derived by granting US investors there tax credits to offset the double taxation of business income, as both corporate earnings and dividends that are now granted British investors in their own country. But while American investors would benefit by the terms of the treaty, American states could suffer.

Embodied in the treaty is prohibition against states employing a simplified method of deriving the taxes due them from British corporations operating within their borders. Instead, they would be compelled to utilize a cumbersome accounting practice that even with the promised assistance of the U.S. Treasury might be beyond their capacities. There have been wide-ranging estimates of the potential revenue losses to the states. Ultimately, the effect will depend upon whether the United Kingdom accord becomes a model for other US tax treaties with other nations.

But whatever the impact — and Treasury argues that the net result could be an increase in revenues for some states — the effect of the accord would be to embody in a treaty which neither the states themselves nor their representatives in the House had any role in drafting, a limitation on state taxing policies and prerogatives.

Foreign investors in the United States have every right to demand that they are taxed fairly by the states, that taxing formulas are not jiggered from place to place and time to time. Yet the states clearly have the right to establish their own fair procedures or, at the least, to participate fully if Washington constricts that right.

In light of these considerations, there is a strong movement afoot in the Senate to attach a reservation to the United Kingdom tax treaty voiding the section dealing with state taxing policies. It has the support of Massachusetts tax officials, as well as those in numerous other states, and it is a reasonable course.

Mr. STEVENS. Mr. President, I want to call particular attention to the problem that Alaska has with regard to this U.K.-U.S. treaty. As I have already pointed out, article 9(4) is a very serious step so far as Alaskans are concerned. As a matter of fact, it is nearly disastrous in terms of Federal interference with the procedures that have been adopted by my State and which, as the Senator from Idaho has stated, have won the approval of major international corporations such as Exxon. If it has not been placed in the RECORD, I ask unanimous consent that the Exxon advertisement that was run in various publications from November 1977 through April of 1978 be placed in the RECORD at this point.

[p. 18428] There being no objection, the advertisement was ordered to be printed in the RECORD, as follows:

LET'S TALK . . . AMOUNT "EQUALIZING" TAXES

QUESTION. Why are you opposing corporate income tax legislation which would change the method of taxing oil company profits?

ANSWER. Because we don't believe it's equitable to impose a special income tax system on the oil industry alone, and because the proposals would result in a sharp increase in Alaska's oil

industry taxes, which are already higher than in any other producing state.

QUESTION. But supporters of the bill claim they are simply trying to equalize the tax rate. What's wrong with that?

ANSWER. You can't "equalize" taxes by increasing them on one industry only when that industry already pays the highest overall tax rate in the state. In addition, the oil industry already pays income taxes on the same basis as any other multi-state business.

QUESTION. How does the state determine how much of a multi-state company's income is taxable in Alaska?

ANSWER. Under current law, a multi-state or multi-national corporation's total worldwide income is apportioned to Alaska by an equally weighted three-factor formula based on the percentage of the company's total property, payroll and sales in the state. For instance, if the company has 25 percent of its total property, payroll and sales in Alaska, the company pays Alaska corporate income taxes on 25 percent of its total federal taxable income — at the corporate tax rate of 9.4 percent. Variations of this same formula are used in 42 other states and the District of Columbia in calculating income to attribute to multi-state companies.

QUESTION. Would Alaska change the formula under the legislation now proposed?

ANSWER. Yes. One bill would delete the sales factor and substitute an extraction factor. Supporters of the measure ignore the fact that production activity (extraction) is measured by the property and payroll factors and that Alaska also already levies a high tax on production through the severance tax. Another proposal is a separate accounting bill. We believe Alaska's present income tax law as it is applied to the oil and gas industry in Alaska is equitable and provides uniformity with other industries and most of the other states that levy income taxes. A departure from this uniformity could result in overlapping taxation by the states.

QUESTION. Do the two corporate income tax proposals now before the Legislature have anything in common?

ANSWER. Yes, both would result in multi-billion dollar tax increases on oil companies over the life of the Prudhoe Bay field. Both could discourage future resource development in Alaska at a time when most Alaskans would rather see increased job opportunities instead of increased general fund surpluses.

MR. STEVENS. Now, we are concerned enought about this treaty with the United Kingdom, but we are even more concerned about the precedent that is being set here. In effect, the Federal Government is using its treaty power to tell the State of Alaska, and other States, what they can and cannot do with regard to the taxation of foreign corporations.

In my State it is bad enough to deal with the corporations that come from one United Kingdom, but if the same principle is applied to our relationship with corporations that come from Canada, or the corporations that come from Japan, we are going to be completely at the mercy of the Federal treaty power as it affects our relationships with foreign corporations.

Japanese corporations own or control over 70 percent of the timber production and wood products activities in my State. They own or control more than 50 percent of the shore-based fish processing facilities in my State. We tax those Japanese corporations under this same approach that is being condemned in the U.K. treaty.

We have many Canadian corporations operating in my State. As a matter of fact, the corporation that is doing the exploration on the naval petroleum reserve of Alaska, the old Naval Petroleum No. 4, is a Canadian corporation. Our present method of taxing these Canadian corporations would be condemned if this provision were extended to a treaty with Canada.

There is no reason for the Federal Government to take this step in connection with the United Kingdom unless it is setting a precedent. We see this as a step toward dealing with Japan or Germany or Canada, the major trading partners of the United States, on the same footing as with the United Kingdom under this treaty.

I think a lot of people who are proponents of this treaty ought to look at their whole card because they do not deal very much with the United Kingdom. Alaska does because of the involvement of the international oil industry in the North Sea and in Alaska on a substantial basis. But we also deal with Japan; we also deal with Germany; we also deal with Canada on a massive basis, as do the majority of the States of this Union, and in particular the eastern seaboard, where the major support for this U.K. Treaty comes from. They are the ones ~~who are going to be~~ most harmed by the extension of this principle to the corporations that originate in Canada, or the corporations that originate in Germany or in Japan.

We think it is a very, very bad precedent. The Governors of the West are united on this matter. There are some 42 States that use a portion of the approach that has been adopted by Alaska. That was pointed out by Exxon in the ad that I put in the RECORD:

The ad states:

Variations of this same formula are used in 42 other States and the District of Columbia in calculating income to attribute to multi-state companies.

We are dealing with two concepts: The foreign corporation and the domestic corporation which is foreign to a particular State. I say that the net result of this will be a massive shift in the States approach to income taxation which is going to disrupt the total income picture of international corporations more than this one approach, which has been acceptable to 42 States.

It would not be utilized, Mr. President, in 42 States and the District of Columbia if it had been totally unacceptable to those people who are involved in the multinational business. But I feel that what has happened here is that someone has found a way to get some of these impounded funds from the United Kingdom back to the United States, and using that as a carrot, and using the treaty power of the United States, the Federal Government is invading States rights.

It is invading the right of a State to determine how to tax nonresident corporations. The precedent will come home to haunt

the very people, including my good friends from New York and Rhode Island that are managing the proponents' side of this treaty. It is a mistake; and I predict I will live to see the day, as a Senator, when this concept is extended to Canada, Japan, and Germany, and the very people who are arguing for it now will argue against it.

If that day every comes, and this treaty should happen to be approved tomorrow, I hope to be able to add some kind of a provision which declares this treaty null and void, because it embodies a concept which, as far as the national policy of the United States is concerned, and the relationship of the Federal Government to the sovereign, independent States, is wrong.

I do not know what some of us are going to do about it because there do not appear to be enough States interested in the relationship with the United Kingdom. When it comes to Japan or Germany, though, there will be interest, and when it comes to Canada there will be interest, because then it will involve the automobile industry, the steel industry, and some more vital industries. So, while I anticipate losing tomorrow, I want to tell the people of this country it will not be for long. When this treaty concept is carried into the relationship with the major trading partners of the United States, it will be reversed, and I think we can rest assured that the country will come to its senses, and that the United States, at the Federal level, will stop interfering with the taxing powers of the States.

Mr. PELL. Mr. President, we have heard some exceedingly cogent and well-thought-out speeches in opposition to article 9(4) of the United States-United Kingdom Tax Treaty. I have the greatest regard for our colleagues who advocate reserving on the article. There are, however, a couple of points we should examine.

First, let us look at the unitary tax system. We agree it is constitutionally legitimate. We are aware that it is being employed at this time in three States — California, Oregon, and Alaska — and is being contemplated for use in other States.

But even though it is compatible with our Constitution, it does, I think, have a hint of unfairness about it. For example, let us take

the hypothetical case of a British company which has a chocolate manufacturing plant in Africa and has a razor blade company in California. The razor blade company in California is doing very badly; the chocolate factory in Africa is doing very well.

Under the unitary tax system, California would be empowered to levy a heavy tax on the razor blade factory even though it was actually losing money. On the other hand, under African [p. 18429] tax laws, we might find either that the chocolate factory was paying excessive taxes or that it was exempt from taxation. The point of this example is to demonstrate the under the unitary system, the taxation is not being levied where the business is created.

I agree with the proponents of the treaty that the British refund of the advocate corporation tax provides an instant windfall by nature of its retroactive application. Personally, I am surprised by the magnitude of the British concession, but speaking as an American Senator, I am delighted with it, because one cannot regret, but rather must be pleased, when American subjects, be they corporations or individuals — and I recognize that two-thirds of the beneficiaries of the retroactivity will be corporations — benefit this way from a windfall. Eventually, it assumes to the good of America, and it must be remembered that there will be increased taxes levied on these retroactive tax rebates.

The question has been raised as to whether there have been other treaties in this regard that affected the taxing powers of individual sovereign States. I think there have been. My understanding is that the 1959 Friendship, Commerce, and Navigation Treaty with France specifically prevents State taxation of French companies except regarding properties located in such States, income or profit derived from activities within the State, or business which French companies do in that State.

This treaty pointed at directly the same problem, and was approved in 1959. Moreover, I think that if one examines the federalist papers, and contemplates the early days of our constitutional hearings, one must realize that our Founding Fathers knew exactly what they were doing when they pointed out that treaty law dominates State law. What was valid then is valid now.

In connection with the benefits, I think we should bear in mind that certainly there are benefits and losses. Of the three States that incur losses, California will incur the most, But let us look at what the benefits are as well.

On balance, I think of U.S. nationals, be they citizens, be they corporations, or be they — and I have had a good deal of mail on this subject — the spouses, or spice, whatever the plural is, of American citizens living in the United Kingdom; they have been very unfairly treated in the past, and this treaty makes their treatment fair.

I think when you look at the general balance sheet, and realize the increased investments that will probably result from the treaty, and the taxes that will be levied on them, you will see that this treaty is very much to the benefit of U.S. citizens and corporations, and there is nothing wrong with that.

Mr. President, I ask unanimous consent to have printed in the RECORD at this point a table giving an approximate idea of the concessions and the gains from this treaty. I think a perusal of that table will convince any of our colleagues who reads the record of this debate that the United States gains substantial benefits from this treaty.

There being no objection, the table was ordered to be printed in the RECORD, as follows:

Proposed U.S.-U.K. income tax treaty: U.S. benefits and concessions as compared to present treaty.[1]

U.S. BENEFITS

1. The U.K. will refund the full ACT to U.S. portfolio investors. Payments about $25 million per year. Negligible Federal revenue impact: some state revenue gain.

[1]Table does not refect concessions and benefits in present treaty, as compared with internal law, which are not changed in proposed treaty, e.g., exemption of interest and royalties from withholding in source country.

2. The U.K. will refund one-half of the ACT to U.S. direct investors. Payments about $60 million per year. Federal Revenue gain $10 to $15 million: some state revenue gain.

3. ACT refunds are retroactive to 1973 for portfolio investors and to 1975 for direct investors. Total U.K. payments in 1978 for the retroactive period will be $375 million revenue gain for retroactive period $50-75 million.

4. The U.K. has agreed to apply the principles in the new U.S. income allocation regulations (section 861). Possible revenue gain.

5. The treaty removes discrimination against U.S. women married to U.K. domicilairies. Slight revenue gain.

6. U.K. entertainers subject to U.S. tax if gross remuneration exceeds $15,000. Minor revenue impact.

U.S. CONCESSIONS

1. The U.S. will credit the U.K. Petroleum Revenue Tax (PRT). Revenue effect negligible.

2. States are limited in the application of unitary apportionment to U.K. owned corporations. States estimate state revenue cost at $30 million. Treasury estimates little or no cost to states.

3. The U.S. will exempt British insurance companies from excise on premiums. Little basis for revenue estimate: probably well under $25 million for the 1975-1978 period and $5-10 million for 1979.

4. The U.S. will reduce withholding rates on dividends to U.K. parent corporations. Revenue cost 1975-1978 about $60 million, $16 million per year thereafter.

5. U.S. entertainers subject to U.K. tax on gross remuneration exceeds $15,000. Minor revenue impact.

6. U.S. agreed that U.S. citizens resident in U.K. should be treated under the treaty as U.K. residents. This will have no U.S. revenue impact.

Mr. PELL. Finally. the State that presently benefits most from the unitary system of taxation, California, has its Governor and its two Senators squarely in support of this treaty. Why? Because they do not see it with the narrow blindness of the taxing authority alone, or the Franchise Tax Board, as it is called. They see it through the wider perspective of Senators or a Governor and are looking at the overall benefits to that State. They hope and believe — or they would not take the position they do — that the application of this treaty will lead to the benefit of California.

For all these reasons, on balance, I believe it is to the advantage of the United States to move ahead with this treaty and not regret that a windfall may occur.

Let us say that a windfall does occur. In the United States, when anyone has a windfall, we should all say hurrah, as long as taxes are paid on that windfall. Lord only knows U.S. citizens and corporations are taking a beating, taxwise, throughout the world today.

Mr. JAVITS. Mr President, I yield myself 10 minutes.

The PRESIDING OFFICER (Mr. Matsunaga). The Senator from New York.

Mr. JAVITS. Mr. President, I ask unanimous consent that floor privileges be extended to Jon Fleming of Senator Cranston's staff and Jacques Gorlin of my staff.

The PRESIDING OFFICER. Without objection, it is so ordered.

Mr. JAVITS. Mr. President, I believe we have debated this subject as far as we can tonight, but I would like, before we end this part of the debate and go over until tomorrow, to correct certain impressions which may have been created by the debate, so that Members who may read the RECORD will have a complete rather than an incomplete record.

In the first place, Mr. President, the question has been raised as to the revenue loss to the States now using the unitary method of taxation.

Let us remember, and I again repeat, that there will be taxes paid on the $375 million which will come in to U.S. investors, and that thereafter there will be a benefit at the rate of $85 million a year, which is also very appreciable.

As to the losses to individual States, Senator PELL and I have already inserted into the RECORD the telegram of the Governor of California, which shows that as far as they are concerned, we are talking about $15 million or $20 million, and they are by far the biggest State. They are confident they will more than make up for that loss of revenue through an improved investment climate in the State.

Aside from that, I refer to a letter dated February 24, 1978, addressed to Steven Emerson, of the Subcommittee on Foreign Economic Policy of the Senate, by the international tax counsel of the Office of the Secretary of the Treasury, H. David Rosenbloom, I wish to highlight it.

In any event, in assessing the estimates made by California, Alaska, and Oregon, please bear the following facts in mind. If one assumes the existence of a 9 percent corporate rate (the California rate), an estimate of a $30 million loss in revenue means that approximately $333 million of income is escaping taxation. Since Article 9(1) of the proposed Convention allows states to use the same arm's-length method of determining transfer pricing that is available to the Federal Government, the above-mentioned $333 million must be escaping not merely state taxation, but federal taxation as well.

After some calculations he goes on in the letter to make it clear that even the estimate of loss of $30 million of revenue is rather high. Therefore, I submit that that is a very substantial bit of evidence backing up what I have said, especially in view of the statement of the Governor of California that it means $15 to $20 million to California which, in relation to the other two States, Alaska [p. 18430] and Idaho, is larger by 20 to 1 in terms of population and, therefore, in terms of the business that is likely to be done in that particular State.

The other thing that I wish to emphasize is that the arm's length method which most States use is an entirely appropriate and fair method of taxation.

Mr. President, I ask unanimous consent that a rebuttal prepared by the Treasury Department on that subject answering the charge that the arm's length method imposes more burdens on the taxpayers than the unitary method be printed at this point, in the RECORD, together with another Treasury rebuttal to the charge that the unitary method is the most reasonable and equitable approach to allocate income.

Mr. President, that is just not so. These statements, which are very professional, make this very, very clear.

There being no objection, the material was ordered to be printed in the RECORD, as follows:

The Arm's-Length Method Imposes More Burdens on Taxpayers Than the Unitary Method

Rebuttal: The unitary method as applied internationally required foreign affiliates of companies doing business here to keep records and books in English and in U.S. tax concepts even if these affiliates never do business in the United States or never engage in a business transaction with a company that is operating here. Thus, all foreign affiliates have significant burdens imposed upon them by the unitary system. In sharp contrast, the "arm's-length" method — the method used by the Federal government domestically and internally and the method used by most states internationally — only involves a foreign affiliate when that affiliate engages in a business transaction with a company doing business in the United States. And that foreign affiliate may only be concerned with U.S. record-keeping to the extent of its transactions with that U.S. affiliate. A foreign affiliate that has no office here but brings from or sells to a related company present here need not, under the arm's-length method, even produce its books and records less it appears to the tax authorities that a transaction does not clearly reveal income in contrast, the unitary system requires the production of foreign books and records by that foreign affiliate in all cases. In short, it is clearly inaccurate to

state that the unitary method imposes fewer burdens on taxpayers that does the arm's-length method. In fact, the opposite is true.

The Unitary Method is the Most Reasonable and Equitable Approach to Allocate Income.

Rebuttal: The unitary method has certain advantages when used domestically by the states. Economic conditions in the United States are comparable; valuations of sales, property and payroll do not vary greatly between the states. This is not the case internationally. The cost of labor and property is substantially lower in developing countries than, for example, in California, but the three-factor unitary apportionment formula operates as if the costs were the same. Due to such differences in costs, plus a lack of uniformity with respect to foreign and state rules on allocating income, the unitary system almost assuredly creates substantial distortions and double taxation of income when appeared in the international arena.

Mr. JAVITS. I would like to read to my colleagues from a letter that Assistant Secretary designate Ulrich answering the concerns about the effect of the treaty on the ownership of U.S. farmland:

The proposed treaty does not in any way create a tax preference for foreign ownership of U.S. farmland. The proposed treaty contains no provisions specifically addressed to the taxation of farmland. The treaty does provide in Article C that all U.S. real property income is taxable in the United States under normal Federal tax rules. This would include income derived from farmland. The treaty most certainly would not prevent the states from taxing farm income.

As explained in Secretary Blumenthal's letter, there are a few limited situations where pursuant to Article 9(4) of the proposed treaty states may not use the so-called unitary method in taxing profits. At the present, there are only three states that would be affected by Article 9(4) — California. Alaska and Oregon. In the limited situations where the unitary method of taxation may not be used, the states are allowed under the treaty to use the arm's length method of controlling prices in transactions between related parties. There is a wide market for agricultural products and

it is, therefore, very easy to obtain arm's length prices and to avoid any possible shifting of profits. Moreover, Federal audit information is available to state tax authorities for the purpose of determining an arm's length price.

We understand that the concern with respect to the taxation of farming profits is primarily directed at Japanese interests and not the United Kingdom. Of Course, the proposed treaty with the United Kingdom does not in any way relate to Japanese investment.

Another argument with respect to the treaty's impact on farmland is that the treaty would somehow prevent the states from requiring that farmland be owned by domestic corporations or domestic persons. This argument is totally incorrect. The proposed treaty does not contain any rules affecting state laws with respect to the rights of foreign persons to own U.S. farmland or any other type of land. Although there is a non-discrimination article in the proposed treaty, this article only applies to Federal and state laws with respect to *taxation*. The non-discrimination article in the proposed treaty is the same in this respect as non-discrimination articles already contained in our current treaty with the United Kingdom and sixteen other U.S. tax-treaties. None of those treaties require the states to alter any rules with respect to land ownership.

Mr. President, I think it is very important to address oneself to the attempt to turn down the whole treaty through the insertion of this reservation, which is an indirect rather than a direct way of trying to defeat it directly.

It seems to me that we must be very cautious in arguing against the free flow of international investment. The encouragement of investment in this country and the investment by our nationals in other countries represents the fundamental strength of our world. That is the way in which developing countries can be developed; in which industrialized countries can be helped through difficult periods such as Great Britain has had.

Furthermore, the provisions in the treaty are extremely limited rather than broad, which I must again emphasize at this point. The treaty does not prohibit States from applying unitary taxa-

tion. It does not affect unitary taxation of U.S. corporations, nor does it affect foreign corporations controlled by U.S. persons, or even by persons from countries other than the United Kingdom, nor does the treaty prevent the application even of unitary taxation to the operation of foreign corporations which do an aggregate business in the several States of the United States.

Indeed, unitary taxation may be applied freely where the universe to which the tax is directed is a universe of business done within the 50 States, within the United States itself. Therefore, in view of the limitations and in considering what is at stake, the amounts which are involved in lost tax revenues to the individual States which use this method, appear to be minor. In view of what we are getting back in terms of retroactive and future payments, and the non-discrimination against the U.S. directed portfolio investments, it seems to me that the treaty represents a very sound arrangement in the interests of the United States and the business system of the United States. It ought to be ratified, as indeed it was recommended by a 2 to 1 vote in the Foreign Relations Committee on this very issue when exactly the same arguments which we have heared here on the floor were made.

* * *

Exhibit 36D

[EXCERPT FROM CONGRESSIONAL RECORD]

[p. 18651] EXECUTIVE SESSION

TAX CONVENTION WITH THE UNITED KINGDOM OF GREAT BRITAIN AND NORTHERN IRELAND — EXECUTIVE K, 94TH CONGRESS, 2D SESSION

Mr. ROBERT C. BYRD. Mr. President, I ask unanimous consent that the Senate now go into executive session to resume its consideration of the United Kingdom Treaty.

* * *

Mr. HAYAKAWA. I thank the assistant minority leader.

Mr. President. I rise today in support of the United States-United Kingdom Tax Treaty which is now before the Senate.

[p. 18652] Some of my colleagues in this Chamber may not be aware that I was one of the early supporters of this treaty. Actually I supported it at a time when not only my senior colleague from California but also Governor Brown of California opposed this treaty. I am happy to see today that both gentlemen in the meantime have changed their position and are now supporting the treaty.

The initial opposition of my State to the tax treaty was based on a statement by the Franchise Tax Board of California — that its implementation would entail an annual tax loss of $120 million. This is an argument that never convinced me.

As it turned out the figure itself was exaggerated. Moreover, the tax board chose to disregard the obvious; namely, that a more reasonable tax would act as a powerful incentive for foreign-owned multinational corporations to invest in California or to expand their existing investments. To put it in simple terms, the California Franchise Tax Board was million-wise and billion-foolish. It disregarded the tremendous economic uplift to California in the form of increased investments, payrolls, purchasing power, and therefore taxes which an influx of foreign-owned companies would provide for California. Unfortunately, the

Franchise Tax Board's arguments neglected long-term considerations.

My emphasis on the opportunities which the unitary tax system eliminates is based on considerable evidence. Naturally I did not have the possibility of conducting a worldwide survey. But I had numerous talks with the Japanese-American Trade Council which strongly supports my point of view. Moreover, the California First Bank, which is the California branch of the Bank of Tokyo, had the following to say on the subject:

Your support of Article 9, Paragraph 4 of the pending US-UK Tax Treaty, will substantially assist the many California firms, such as California First Bank, which are presently being unduly burdened by the combined reporting (unitary) method of tax assessment as presently administered by the California Franchise Tax Board.

Should you have the opportunity to represent the interests of the State of California, you may feel free to bring to the Senate's attention a significant point relative to California First Bank, the State's eighth-largest bank.

Arbitrary administration of the assessment method may jeopardize the interests of our some 3,000 plus minority shareholders in the U.S., whose equity may be reduced by assessments based not on our California income, but on the worldwide income of our parent bank in Japan.

I also received a supportive letter from the Japan Traders' Club of Los Angeles which explains the position of the Japanese business community:

In behalf of Japan Traders' Club of Los Angeles, a nonprofit California corporation consisting of 280 United States subsidiaries, branches, and representative offices of major Japanese corporations, I would like to express my grave concern about Unitary Taxation in the State of California.

As you know, many Japanese corporations have already invested substantial amounts of funds in California. At the time, our member corporations were not aware of their intention to apply the Unitary concept to such a degree.

I strongly feel that Japanese investment in the United States should increase in order to create more employment in this country and, at the same time, help to offset a part of the trade imbalance between the United States and Japan.

We are willing to pay our fair share of corporate tax that relates directly to our United States operations. However, under this Unitary Taxation, world wide operations of the entire corporate group of companies both in and outside the United States are taken into account. The impact of this method of taxation on our member firms especially as it is exerted retroactively for 4 years is indeed severe.

If this state, which is geographically advantageous as a part of the Pacific economic basin of Japan, continues to practice the concept of Unitary Taxation, it will result in the impeding of Japanese investment in the United States at her gateway.

We are hopeful that through your good offices you will be able to emphasize to the policy and lawmakers in the Federal and State governments that such a taxation method should be eliminated.

I wish to add that this matter of a trade imbalance between the United States and Japan is a matter of great concern to Japanese businessmen, both those in Japan and those Japanese businessmen doing business in the United States. I, as my colleagues know, was in Japan and I heard this both from the Japanese people themselves and representatives of the Government and also from businessmen in California. They are very, very eager to redress this matter of trade imbalance.

In Japan, incidentally, firms like Nissan Motors, which manufactures the Datsun automobile, Toyota, Sony Electronics, the Honda Motor Co. — these are all companies that either are contemplating enlarging their present facilities in California, as in the case of Sony, or in the case of Honda, Nissan, and Toyota seriously considering putting in assembly plants in California.

These are all people who in one way or another will be doing business in the United States, and the unitary tax system is a formidable barrier to them, as told to me personally by the heads

of these organizations.

Mr. President, I shall make some brief comments about the so-called unitary tax system itself. It is covered in article 9(4) of the treaty.

It is well established that in appropriate cases the business of a single corporation may be treated as unitary in nature and that the total income of such a corporation may properly be apportioned under a formula that fairly attributes a proportionate part of the corporation's income to a particular State.

When applied in a multicorporate setting, however, the "unitary business" doctrine of combined reporting requires that a corporation with a business location in the State includes in its apportionable tax base not only the entire income of such corporation within the State, but also the income of such of its worldwide affiliates as are found by the State to participate with the corporation in a single business unit.

This broad approach to corporate taxation can in effect result in taxation by the State of the income of corporations that have no real contact or connection with the State. Since this tax is not applied by all States, the "unitary business" concept can result in more than 100 percent of a company's income being subjected to State taxation or can result in a company paying tax on an allocable portion of the entire income of another corporation, even though there is not complete unity of ownership between the two corporations, for an example, the subsidiary is only 51-percent owned. Suppose the Japanese firm or the British firm is 100-percent owned by the Japanese or Britain but the subsidiary is only 51-percent owned and the other 49 percent is being owned by American investors. This is the kind of illogical situation that results.

Finally, as it has been interpreted by a few States, such as California, the "unitary business" concept results in the apportionable tax base of a corporation with a business location in the State, even though the activities in the State in no way contribute to the earning of such foreign income.

As indicated, I am opposed to the application of this unitary

business doctrine to multinational corporations. In my opinion, it impinges on the foreign relations of the United States.

Opponents of the treaty argue that the provisions in the proposed treaty are a flagrant usurpation of — the State's — legislative powers. In reply I cite the Foreign Relations Law of the United States, which in paragraph 117, dealing with the scope of international agreements, has the following to say:

(1) The United States has the power under the Constitution to make an international agreement if

(a) The matter is of international concern, and

(b) The agreement does not contravene any of the limitation of the Constitution applicable to all powers of the United States.

I also would like to cite from the remarks of the eminent lawyer Charles Evans Hughes when he spoke in 1929 before the American Society of International Law.

I take the view which I understand to be that of the Supreme Court that this is a sovereign nation; that the states, in relation to foreign affairs, are not sovereign states; that if this nation exercised its sovereign power in regulations to other nations it must be done through the exercise of the treaty-making power and in that relation there are no states, there is but one country.

In the past, there were some cases when the treaty-making powers of the United States were challenged by individual States, but the Supreme Court ruled in favor of the United States.

Mr. President, my final comments pertain to article 10 — dividends — and article 23 — elimination of double taxation — of the proposed treaty. There can be no doubt that if article 9(4) should be eliminated, the United Kingdom would insist on renegotiation of the treaty. Like many treaties the document before the Senate is based on the principle of "Give and Take." The dividend provision of the United States-United Kingdom Tax [p. 18653] Treaty reflects a major concession by Great Britain. If article 9(4) fails, the dividend provision undoubtedly will also be eliminated. Let me explain.

In 1973 the United Kingdom introduced a partially integrated system under which a portion of the tax collected at the corporate level is treated — with respect to distributed profits — as having been paid on behalf of resident individual shareholders.

Under the United Kingdom system, United Kingdom corporations are subject to an initial corporate tax liability of 52 percent. When a dividend is paid, a tax called the Advance Corporation Tax — or act — is levied. This act is equal to 35/65 of the net dividend and it is credited against the corporation's regular yearend tax liability.

An individual U.K. resident shareholder pays tax not only on the dividend but also on the act paid with respect to the dividend. However, he may claim a credit against his own income tax liability for the act. If he is a "standard rate" taxpayer subject to a 35 percent rate, the credit will exactly offset his tax on the dividend income. If he is subject to tax below the standard rate, he will receive a refund of the excess of the act credit over his tax due. Thus, for a U.K. resident, the act is clearly a prepayment at the corporate level of the shareholder's tax.

However, when the shareholder is a nonresident alien, the situation is quite different. British law provides that the act must be paid upon any distribution, but there is no credit or refund allowed to the nonresident shareholder — corporate or individual.

This treatment discriminates against U.S. investors in the U.K., since for U.K. shareholders the effective underlying corporate tax rate with respect to distributed profits is just over 26 percent while, in the absence of this treaty, for nonresident shareholders the rate remains at 52 percent. This discrimination is potentially of significant dollar magnitude, and must be viewed as a serious problem. The U.S. Treasury concluded that an income tax treaty is probably the only appropriate vehicle for mitigating the discrimination.

The new U.K. system is not a unique or isolated phenomenon, but rather is likely to be the prototype for European tax systems generally. A June 1975 draft directive of the Commission of the European Economic Community calls for adoption of similar integrated corporate/shareholder tax systems by all Common

Market countries. Such a system has been in place in France for some time, and the new tax law in West Germany follows a similar approach. It is therefore, obvious that a precedent must be established early if the United States is to deal effectively in subsequent negotiations with other countries employing integrated systems.

Under the rules of article 10 — dividends — and article 23 — elimination of double taxation — of the proposed treaty, the discrimination is substantially reduced. For U.S. portfolio shareholders, the treaty provides the same credit as that available to a United Kingdom shareholder. The United States-United Kingdom Tax Treaty which is before the Senate — if ratified — will establish the necessary and terribly important precedent. In sum then, Mr. President, the economic interests of the United States clearly demand that this treaty be promptly ratified. I therefore urge my colleagues to rally in support of the treaty.

I thank the Chair.

Mr. JAVITS addressed the Chair.

The ACTING PRESIDENT pro tempore. The Senator from New York.

Mr. JAVITS. Mr. President, I yield myself 1 minute.

Mr. President, I am very grateful to Senator HAYAKAWA for this presentation: first, for the excellence of the text which has been developed and which makes a very strong case for the treaty; and, second, because the presentation is quite indicative of the man.

The State of California started, Mr. President, by being in opposition to this treaty and, indeed, the distinguished Senator from Idaho, who is sponsoring, the reservation we are now debating, cited the State tax commission of California as still being opposed to it.

But, Mr. President, both Senators from California and the Governor are for the treaty, thus I think it is fair to say the State as such supports the treaty.

Senator HAYAKAWA came to his decision after much deliberation. When we first began consideration of the treaty, even before committee hearings, he was doubtful about whether he should support this treaty as being in the interests of his State. He quickly decided to support the treaty. As in my own life, I consider the words "I am persuaded" the proudest words that I can utter, because I am not persuaded easily.

I pay tribute to him because that is what happened in this case, and it is a real confirmation, that Senator HAYAKAWA'S views have been a tremendous lateral support to me in my conviction that support for the treaty was the right way to go, and I am very grateful to him for more reasons than just the normal thanks to a colleague who supports another.

I yield.

Mr. HAYAKAWA. I thank the distinguished Senator from New York for those kind words.

I might add Governor Brown underwent a similar change of heart. He visited Japan without knowing about the United States-United Kingdom tax code, and it was only after he got to Japan that he learned that many Japanese companies were unwilling to come to California for that reason, and he gradually changed his mind on the subject.

Mr. JAVITS. I thank my colleague very much.

I yield myself 5 minutes.

While we are on the problem of Treasury consultation with the States on the treaty, I would like to remind my colleagues that the State Taxing Commission of California had made a very proper complaint to the Treasury about a particular provision of the treaty in which it said it would not only protect against imposition through the misuse of the unitary tax system United Kingdom corporations, but the protection would also be extended to U.S.-controlled companies which had affiliates in the United Kingdom.

The Treasury recognized the propriety of that particular objection and, hence, negotiated a protocol, which is also before us, and

which will be voted on this morning, and the protocol corrects the very objection made by the California taxing authority.

Now, the California Franchise Board is still, as Senator CHURCH of Idaho has said, opposed. But I wish to point out that both for the substantive reasons Senator HAYAKAWA has set forth and because of the Treasury's responsiveness to their complaint which resulted in an amendment to the treaty in a protocol arrived at by agreement in 1976 there was a real and reasonable effort, I think a good-faith effort, to meet the views of California, and I think that is a very important argument in favor of the treaty.

Now, Governors generally, contrary to the impression sought to be created here, have expressed approval of the treaty.

I have before me a letter from Governor Carey of New York, and I ask unanimous consent that it may be included in the RECORD. It is dated June 16, 1978, and it is addressed to me, and it is as follows:

STATE OF NEW YORK,
EXECUTIVE CHAMBER,
Albany, June 16, 1978.

HON. JACOB K. JAVITS,
Senate Office Building,
Washington, D.C.

DEAR JACK: I understand that the Senate will consider for ratification the proposed US-UK Income Tax Treaty at the conclusion of the Labor Law Reform legislation. I also understand that you were instrumental in moving the proposed treaty to its present stage. Since it is my hope that the proposed treaty will improve the climate for investment and new jobs by multinational firms in New York, I wish to express my appreciation for your efforts thus far.

Recently, I expressed my endorsement of the proposed treaty without the article 9(4) reservation in a response to a solicitation for my support from Secretary of the Treasury W. Michael Blumenthal.

You will have my continued support for the proposed treaty as it is brought to the Senate floor for ratification.

Best regards.
Sincerely,

HUGH L. CAREY.

Mr. President, I ask unanimous consent that a letter from Gov. John D. Rockefeller IV, of West Virginia, dated March 3, 1978, may be made part of my remarks. I read that letter, which is addressed to our beloved and distinguished chairman, Senator SPARKMAN:

STATE OF WEST VIRGINIA,
OFFICE OF THE GOVERNOR,
Charleston, March 3, 1978.

DEAR SENATOR SPARKMAN: The proposed income tax treaty with the United Kingdom was signed December 31, 1975 and is presently pending ratification by the United States Supreme Court.

In earlier correspondence to both the President and your Committee, the State of West Virginia had taken the position of opposing ratification of the treaty. This view was based primarily on an analysis of Article 2, Paragraph (2)(c) and Article 9, Paragraphs (4) [p. 18654] and (5) which led us to originally conclude that the treaty would not be in the long term best interests of West Virginia.

After an extensive review and further evaluation of the treaty's provisions, I am now convinced that the treaty is deserving of my support. This change in position is attributable to the following:

(1) West Virginia was originally deeply concerned that certain treaty provisions would be expanded in the future either by treaty or legislation. The primary reason for West Virginia's opposition was that a trend toward greater federal intervention in the tax practices of the states would develop. The Treasury Department, however, recently has informed us that they have no intention of expanding the scope of the treaty in the future.

(2) We estimate that the treaty prohibition on the use of the unitary tax system would reduce corporate tax revenues by approximately $300,000 annually. However, in reviewing the aggregate impact of the treaty, I am now confident that the tax gains to West Virginia by reason of the treaty should more than offset this loss.

(3) I believe the treaty will bring needed equity in the tax treatment of United States corporations conducting business abroad.

(4) Initially, we were also concerned over our ability to vigorously enforce the arms length standard to arrive at the taxable income of separate corporations since the treaty prohibits the use of the unitary tax system. The Internal Revenue Service has recently informed us that data they have developed on arm's length pricing would be made available to state tax administrators and this should solve our problems.

It is for these reasons that I wish to state my support for the treaty and respectfully encourage you and your distinguished colleagues in the United States Senate to vote for its ratification.

Sincerely,
JOHN D. ROCKEFELLER IV.

Now that, Mr. President, is again one of the major arguments for this treaty, to wit, the need to create a better climate for the investment of funds in the United States and to improve the basis for industrial development here by other countries.

So we are putting our feet on the right road in terms of foreign investment in the United States which, in view of the terrible imbalance which we have in our payments, is extremely desirable and in the interests of our Nation.

Mr. President, unless Senator SPARKMAN wishes to yield some time, I am prepared to yield to Senator PERCY.

I yield 5 minutes to the Senator from Illinois.

The ACTING PRESIDENT Pro tempore. The Senator from Illinois.

Mr. PERCY. I thank my distinguished colleague.

I would first like to say that I think we all owe a debt of gratitude to Senator JAVITS for the persistence with which he has worked with the leadership to see that this treaty goes forward, and I wish to express appreciation also to our distinguished chairman, Senator SPARKMAN, for his leadership in this regard.

Mr. President, as the poor managers of the treaty know, I strongly supported the treaty pending before us in the Committee on Foreign Relations. We did have some opposition from the Illinois Department of Revenue and, I think, some degree of misunderstanding by some other people. I would like to state my support again at this time. I believe the treaty will bring highly favorable benefits to the United States.

The treaty will bring significant capital flows into the United States at a time when large foreign holdings of dollars are putting pressure on the value of our currency in foreign exchange markets. It is estimated that there will be an immediate payment of approximately $375 million in U.K. tax refunds to Americans, and additional substantial refunds after that.

Furthermore, the dividend provisions in the treaty are a major favorable development in our Government's efforts to overcome the discrimination against Americans investing in the United Kingdom and in our other major trading partners who use a so-called integrated tax system similar to that of the United Kingdom.

I am aware that there has been a great deal of protest about the restriction in article 9(4) of the treaty on the application of the unitary apportionment tax system. Senator Church is sponsoring a reservation which would effectively cancel this provision. I would point out that the treaty does not prohibit the use of the unitary taxation formula per se. It does not prevent the States from using the unitary taxation method to tax U.S. corporations. Nor does it affect unitary taxation of U.S. corporations, nor does it affect either foreign corporations controlled by U.S. persons or foreign corporations controlled by persons from countries other than the United Kingdom.

Finally, the treaty does not prevent the application of the unitary formula to the operations of foreign corporations doing business in several States in our country.

What it does restrict, Mr. President, is the taxation of income of foreign affiliates with no business in the taxing State. It just says that a State may not take into account the operations of a foreign corporation not doing business in the State if the corporate group in question is controlled in the United Kingdom. As a former businessman, I can attest to the justification in the claim that this application of the unitary taxation formula is grossly unfair.

On another issue, Mr. President, I want to comment on the concern which has been expressed by some parties about the effect of this treaty on foreign investment in U.S. farmland. The fear which has been expressed is that article 9(4) will encourage foreign investment by giving foreign investors an unfairly advantageous tax position. This is certainly a serious concern in Illinois, and I am pleased that the Department of the Treasury has done a good job of setting the record straight in a statement submitted to the Senate in May of this year in behalf of the Secretary of the Treasury:

The proposed treaty does not in any way create a tax preference for foreign ownership of U.S. farmland. The proposed treaty contains no provisions specifically addressed to the taxation of farmland. The treaty does provide in Article 6 that all U.S. real property income is taxable in the United States under normal Federal tax rules. This would include income derived from farmland. The treaty most certainly would not prevent the states from taxing farm income.

There are a few limited situations where, pursuant to Article 9(4) of the proposed treaty, states may not use the so-called unitary method in taxing profits. At present, only three states would be affected by Article 9(4) — California, Alaska and Oregon. In the limited situations where the unitary method of taxation may not be used, the states are allowed under the treaty to use the arm's length method of controlling prices in transactions between related parties. There is a wide market for agricul-

tural products and it is, therefore, very easy to obtain arm's length prices and to avoid any possible shifting of profits. Moreover, Federal audit information is available to state tax authorities for the purpose of determining an arm's length price. Thus, the limited restriction on use of the unitary tax method should not permit foreign corporations to escape state taxation on U.S. farm income through artificial pricing practices.

The ACTING PRESIDENT pro tempore. The Senator's 5 minutes have expired.

Mr. JAVITS. I yield the Senator 5 more minutes.

The ACTING PRESIDENT pro tempore. An additional 5 minutes is yielded the Senator from Illinois.

Mr. PERCY. Mr. President, I urge my colleagues to support the proposed treaty and to vote against attaching a reservation to article 9(4). It is beneficial to the United States, it encourages the free flow of trade and investment, and is an important contribution to our Government's policy of promoting international economic cooperation.

Mr. JAVITS. Mr. President, I thank Senator PERCY. He is a man highly experienced in business. This tax treaty is essentially a business stimulant, and his support for it is extremely valuable.

I would also like to add this: I heard with great interest and with great respect Senator CHURCH say last night that this was a treaty for the interests of the rich people.

Well, Mr. President, we have 90 million people employed in this country; 90 percent of them are employed by American business enterprises. I fail to see how populism can fail to include the employers as well as the employed. That is the only way that jobs can be created.

I value Senator PERCY'S support for this treaty. With all respect, I think he is just as populist minded, and his area of the country is just as populist minded, as our distinguished colleague from Idaho and his region. But he has business experience and he knows what makes the merry-go-round. I value very much, therefore, his support of the treaty.

Mr. SPARKMAN. Mr. President, I yield such time as the Senator from Rhode Island may require.

Mr. PELL. Mr. President, I believe the question of the attitude of the farmers and the impact upon farms was raised by the Senator from Illinois. In this regard, I have been told that Mr. W. E. Hamilton, chief economist of the American Farm Bureau Federation, the largest farmer organization in America, has informed the various federation offices that while the federation has taken no position on the U.K. Tax Treaty, he [p. 18655] found nothing in the treaty with which he could take exception. I thought this viewpoint of the American Farm Bureau should be put into the record as they are the largest representative of the farming industry.

* * *

Mr. JAVITS: Mr. President, I yield 5 minutes to the Senator from Alaska.

Mr. STEVENS. I appreciate that, Mr. President.

Mr. President, at this point in the debate on the United States-United Kingdom Tax Treaty, I should like to provide for the record resolutions calling for a reservation of article 9(4) of this treaty, the reservation proposed by the Senator from Idaho. The resolutions were passed by the Western Governors Conference, the National Association of Tax Administrators, the National Conference of State Legislators, and the National Association of Attorneys General. I have also received letters and telegrams expressing opposition to article 9(4) unless it is subject to a reservation such as we support here. These letters and telegrams have come from the Multistate Tax Commission, the AFL-CIO, the Consumer Federation of America; the Service Employees International Union; the American Federation of State, County and Municipal Employees; the Oil, Chemical, and Atomic Workers; the International Association of Machinists; Ralph Nader's Tax Reform Research Group, the Energy Policy Tax Force; Common Cause; and the Ohio Public Interest Campaign.

Mr. President, since I have served in the Senate I have never seen an issue in which the spectrum is so broad to protect States'

rights. To have Mr. Nader's Reform Research Group together with the Consumer Federation of America and the Multistate Tax Commission, all of these union organizations, together with the national conference of all the legislators of all the State legislatures of the Nation, expressing opposition to this tax treaty unless article 9(4) is subject to this reservation, I think, ought to make other Members of the Senate think twice before they support this treaty without the reservation.

Mr. President, I ask unanimous consent that these resolutions and items be printed in the RECORD at the conclusion of my remarks.

The ACTING PRESIDENT pro tempore. Without objection, it is so ordered. (See exhibit 1.)

Mr. STEVENS. These resolutions state categorically the position of those who are most familiar with State taxation in this country.

In particular, I call the attention of the Senate to the National Association of Tax Administrators and their meeting held in Atlanta, Ga., in June of 1976, where they expressed their total opposition to this unprecedented action of the executive branch wherein the U.S. Government has, in secret bargaining with a foreign country, sought to limit our sovereign States' taxing powers.

They have sought to do so in a way that benefits foreign multinational corporations. Our domestic multinational corporations, as exemplified by Exxon, have taken the position that the action of 42 States and the District of Columbia is acceptable to our domestic international corporations. This tax treaty is designed to give solace to foreign international corporations which do business in this country.

The National Association of Tax Administrators has announced its opposition not only to this treaty but to the action of the Federal Government with respect to these foreign multinational taxpayers and urge that the State legislatures take action to express their opposition, also.

As a result of that request, in September of 1976, the president of the National Conference of State Legislatures, who is also the president of the Colorado State Senate, sent to the Foreign Relations Committee a very thoughtful letter, which contained as an enclosure the policy position of the National Conference of State Legislatures. That national conference urged Congress to delete from this treaty the provisions which would infringe upon the separate tax systems of the States and governmental units and urged us to place reservations on the treaty that would forbid the States from utilizing the unitary taxation system.

That was followed, Mr. President, by action of all the attorneys general of the States of our Union when they met in Baltimore in September 1977. I am informed that the National Association of Attorneys General unanimously opposed the provision of this treaty which would impinge upon State taxation and the rights of States to determine their own State tax policy. That, too, was followed by the action of the Western Governors of the United States when they passed the resolution which I have asked to have printed in the RECORD. They passed it at their meeting in September of 1977.

We in Alaska and, particularly, those in the West, developed the unitary tax method as being the best way to apportion income among foreign multinational corporations that do business in several States of the Union. This reservation today ought to be given support by the Senate because, if we permit the United Kingdom Treaty to be used as a first vehicle for the adoption of restraints upon States' taxing power through the use of the treaty power of the executive branch. I believe the ultimate net result will be, that Canada, Germany, and Japan, in particular, will ask for similar treatment.

When that day comes, those people who have indicated their support here on the floor for this treaty, because of the little quid pro quo of returning the stockholders' impounded dividends from the British Empire to the United States will suddenly find themselves staring at the question of whether or not we will discriminate against our major trade partners and not give the multinational foreign corporations that originate in Canada, or in

Germany, or in Japan, the same treatment we have agreed to give those that originate in the United Kingdom.

I again, Mr. President, call attention of the Senate to the broad spectrum of opposition throughout the United States as expressed by the Attorneys General, the Multistate Tax Commission, the Consumer Federation of America, the employees unions of the Government, the local governments, and in particular those that are related to the public interest task force concept that deal with taxation, Ralph Nader's group, the Energy Policy Tax Force and Common Cause.

With all of those organizations uniting in opposition to this treaty without reservation I hope that the Senate will think twice before it votes on the Church amendment.

I thank the Senator from New York.

Exhibit 1

Resolution Unanimously Adopted at the Forty-Fourth Annual Meeting of the National Association of Tax Administrators, Held in Atlanta, GA., June 16-17, 1976

Resolution Eight

Whereas, both the Executive and Legislative Branches of the Federal Government have under consideration separate proposals which would override state taxing powers and methods, and

Whereas, the Executive Branch, in total secrecy, took the unprecedented action of negotiating and executing a treaty with the United Kingdom which restricts state taxing methods, and substantially reduces the corporate tax revenues for some states for the benefit of multinational corporations, and

Whereas, the United States House Ways and Means Task Force on Foreign Source Income is considering a proposal by Representative Jones to limit states in determining the amount of income derived from state sources to the federal tax base, thereby permitting multinational corporations to manipulate their income

and defer the payment of income taxes by the corporate form through which their activities are conducted, and the geographical areas through which their activities are conducted, and

Whereas, such actions completely disregard and undermine the continuing efforts of the several states to develop a uniform approach to the taxation of multistate and multinational corporations, now, therefore, be it

Resolved, by the National Association of Tax Administrators as follows:

1. That it opposes the unprecedented action adopted by the Executive Branch in secretly bargaining away the states' taxing powers, and in particular because such action benefits only the world's largest multinational corporations which have never established [p. 18656] that they are exposed to tax on all of their income, nor that their effective tax rate is comparable to the tax rate imposed on local corporations.

2. That the National Association of Tax Administrators continues to oppose restrictive federal tax legislation with respect to multistate or multinational taxpayers; and if such legislation is mandated it should not provide preferential tax treatment for multinational corporations, nor permit such corporations to alter tax consequences by the corporate form through which they conduct their activities.

3. That each member state of the National Association of Tax Administrators request their state legislatures to enact appropriate Resolutions urging that the treaty provisions relating to state taxes be reserved, and that Congress not approve any restrictive federal interstate tax legislation.

4. That copies of the Resolution be sent to the following:

(a) President of the United States;

(b) Governor of each state;

(c) U.S. State Department;

(d) U.S. Treasury Department, International Tax Section;

(e) U.S. Senate Committee on Foreign Relations;

(f) U.S. House Committee on Ways and Means;

(g) U.S. Senate Finance Committee;

(h) U.S. Joint Committee on Internal Revenue Taxation; and

(i) U.S. House of Representatives Ways and Means Task Force on Foreign Source Income.

5. That the Executive Secretary request permission to attend any public meetings regarding the pending treaty and the task force proposal or similar proposals which may be considered by the House Ways and Means Committee, Senate Finance Committee, or the Senate Foreign Relations Committee, and urge that the parts of the treaty relating to state taxes be reserved, and that any task force or Senate Finance Committee proposal to limit state taxes or state taxing methods be rejected.

NATIONAL CONFERENCE OF STATE LEGISLATURES,
Washington, D.C., September 9, 1977.

HON. JOHN J. SPARKMAN,
Chairman, Senate Foreign Relations Committee,
Dirksen Senate Office Building, Washington, D.C.

DEAR SENATOR SPARKMAN: As President of the National Conference of State Legislatures, I am writing to inform you of our recently adopted position on the United States-United Kingdom tax treaty. The National Conference of State Legislatures is the non-partisan organization representing the nation's 7,600 state legislators and staff.

We would like to encourage you and the Foreign Relations Committee to place reservations on those sections of this treaty which would infringe upon the separate tax systems of the states. With a majority of the states utilizing the unitary tax method to some degree, our Conference unanimously adopted this position calling on the U.S. Senate to delete these restrictions from the treaty. I think it is important to point out that many states are concerned with this issue as evidenced by the support for our position by elected state legislators from all parts of the country.

We do not feel that this treaty should forbid the use of the unitary taxation method by the states. This unprecedented action by the treaty negotiators to intrude into the constitutionally separate tax systems of the states is the basic issue. We do not feel that the proper method of modifying state tax laws should be through the adoption of a treaty by the federal government. The state legislators who are responsible for writing state tax laws are willing to engage in a full examination of the tax laws of both the state and federal governments in order to develop improvements to the methods of taxation of multi-national corporations.

Although the arms-length method of taxation has been proposed by some as the only method states could use to tax multinational corporations, the experience in many states which use this method have pointed out some major problems. Those states which utilize the arms-length approach have not had the necessary cooperation from the Treasury Department to make this an effective approach. Careful study by state legislators, governors, and state tax administrators of taxation methods must take place before we should even consider such a radical step to simply outlaw the unitary tax method.

I thank you in advance for your careful consideration of an issue which raises fundamental constitutional questions. If you or your staff should have any questions, please contact Jeffrey Esser in our Washington Office of State-Federal Relations.

Sincerely,
FRED E. ANDERSON,
President, National Conference of State Legislatures.

NATIONAL CONFERENCE OF STATE LEGISLATURES
POLICY POSITION

UNITED STATES-UNITED KINGDOM TAX TREATY

The National Conference of State Legislatures urges Congress to delete provisions from the United States-United Kingdom Tax Treaty which will infringe upon the separate tax systems of the states and other governmental units. In adopting this treaty, the

U.S. Senate should place reservations on the tax treaty articles that forbid the states from utilizing the "unitary taxation system."

Adopted at the Annual Meeting of NCSL, August 5, 1977, Detroit, Michigan.

RESOLUTION: UNITED STATES-UNITED KINGDOM TREATY AS ADOPTED BY THE EXECUTIVE COMMITTEE OF THE NATIONAL ASSOCIATION OF ATTORNEYS GENERAL EXECUTIVE COMMITTEE MEETING

Whereas, the United States Senate will consider a tax treaty with the United Kingdom which would preempt state taxing power and methods; and

Whereas, adoption of such a treaty would substantially reduce actual and potential tax revenues to the benefit of multinational corporations;

Therefore, be it resolved that:

1. the Executive Committee of this Association opposes provisions in this treaty which represent an unwarranted intrusion of the federal government in tax matters of state concern; and

2. the Executive Committee of the National Association of Attorneys General urges Congress to delete provisions from the United States-United Kingdom Tax Treaty which restrict state taxing methods; and

3. the Washington Counsel of the National Association of Attorneys General is authorized to communicate the position of the Executive Committee to the appropriate members of Congress and the Administration.

FEDERAL INTERFERENCE WITH STATE TAXING POWER

A. ISSUE

Deletion of paragraph 4 of Article IX of the United States-United Kingdom Tax Treaty, regarding the Western states' rights to use the unitary tax method of apportioning taxable income.

B. GOVERNORS' POLICY STATEMENT

The United States Senate Foreign Relations Committee is requested to recommend to the full U.S. Senate that the United States-United Kingdom Tax Treaty not be ratified so long as paragraph 4 of Article IX remains a part of the treaty and restricts the states' power to use the unitary tax concept.

The Governors also feel that such federal interference with state taxing powers is not warranted and contrary to the sovereign interests of all states.

C. FOLLOW-UP ACTION REQUESTED

1. Transmit resolution to the United States Senate Foreign Relations Committee.

2. Transmit the resolution to the Secretary of Treasury.

3. Transmit resolution to the Western Congressional Delegation.

D. BACKGROUND

A tax treaty was negotiated between the United States and the United Kingdom that restricted in paragraph 4 of Article IX, the powers of the states to use the unitary tax method. The restriction on the unitary method prevents the states from using the worldwide combination method of allocating income between states. Three states (California, Oregon and Alaska) currently use the worldwide combination of unitary income method and it is estimated that the passage of the treaty as it presently stands would cost these states an estimated $150 million a year. Several other Western states are contemplating adopting the new concept of tax allocation.

The Federal government attempt to restrict state taxing powers comes at a time when the Western states are making great strides in adopting common practices and uniform regulations in the administration of interstate taxation through the Multi-State Tax Commission.

The ACTING PRESIDENT pro tempore. The Senator from New York.

Mr. JAVITS. Mr. President, I yield myself 5 minutes.

If Senator STEVENS will give me his attention, Mr. President, I happen to be a fan of Alaska. I think I have done many things. I hope, in my lifetime and here in the Senate I may do many more to aid our outpost State in order to develop its fantastic potential.

I would not for a moment try to over-ween the Senator by countering his arguments in some confrontational way. But I would like to point out a number of things which could be helpful. That is the reason I express them.

First, Alaska is an enormous area that needs enormous investment. Not that I am trying to convince the Senator, but I simply wish to commend to the Senator, who is probably the most patriotic advocate one could find of his State, the experience and study made by both the Governor of California and the Governor of West Virginia. I think before the Senator was in the Chamber this morning I read Mr. Rockefeller's letter respecting West Virginia, and it was very instructive as to what he said. West Virginia started out against it and ended up for this treaty.

I would like to reread, if I may, that paragraph. It has gone into the RECORD:

We estimate that the treaty prohibition on the use of the unitary tax system would reduce corporate tax revenues by approximately $300,000 annually. However, in reviewing the aggregate impact of the treaty, I am now confident that the tax gains to West Virginia by reason of the treaty should more than offset this loss.

Comparable experience is interestingly reported by Governor Brown of California. [p. 18657] Again, I would like to refer to the telegram which Governor Brown sent, joined in by Senator

CRANSTON. This morning Senator HAYAKAWA spoke to exactly the same point. The telegram said:

Furthermore, it is the judgment of California's Business and Transportation Secretary, Richard Silberman, and the State Director of Finance, Roy Bell, that ratification of the treaty will have a positive net economic impact on California.

I would like to give the Senator an example of this point.

The Hong Kong and Shanghai Banking Corporation had an interest in a California branch. One of the horror stories about the applications of the unitary tax system by California was to this Hong Kong and Shanghai Banking Corporation holding. Apparently, the State of California taxes them more than their capital because of the unitary system. I understand that now that they have acquired an important interest, perhaps as much as a controlling interest, in the Marine Midland Bank, they are more than happy to sell their interest in their California holding.

Now, in addition, this treaty, as the Senator knows, is heavily supported by business interests which do very broadscale investing.

Finally, the Senator is right about the fact that the United States expects that the countries of the European economic community, will be adopting the same tax integration system that the United Kingdom has already adopted and hence that we can expect that there will be an extension of this principle in other treaties, undoubtedly, with France, the German Federal Republic, and possibly Canada.

Finally and very importantly, the Treasury, and I now make this part of the record and legislative history.

The Treasury has sought to put to rest the fear that article 9(4) is merely a first step toward greater Federal restrictions on State taxing authority, particularly that a provision like article 9(4) will be included in other treaties and that future treaties will go beyond the limited scope of article 9(4) to impose greater restrictions on State taxation.

With regard to the second point, Treasury has no intention of limiting State taxation in future treaties, beyond the type of restrictions provided in article 9(4):

Now, the second point is that future treaties will go beyond the limitations of 9(4). So they negate that.

With respect to the first point, that a provision like 9(4) will be included in other treaties. Treasury has taken the position in discussions with other countries that a provision like article 9(4) cannot be considered until the Senate has acted on the United Kingdom Treaty.

If the treaty is approved, Treasury will consider the inclusion of similar provisions in other treaties, but only in return for commensurate concessions on the other side.

The Treasury does not want to expand the concept beyond these limitations, and I think that is an important commitment to a State like Alaska.

If the reservation is rejected, which I hope is done — and I shall do my utmost to bring it about — I hope the State of Alaska, one, will hold the Treasury to this promise — and I will help the State of Alaska, and I think the Senate will; and, two, that the State will do its utmost to take advantage of a new climate for investment to attract rather than repel foreign investment.

Mr. STEVENS. Mr. President, will the Senator yield me additional time?

Mr. JAVITS. How much time does the Senator want?

Mr. JAVITS. I yield.

Mr. STEVENS. Mr. President, I am indebted to the Senator from New York for that statement, and I believe the record is improved by that statement being in the RECORD.

I say to the Senator from New York that the problem is not solely with this treaty. The problem is that the prospect he mentions, that this concept of using the treaty power to limit the

exercise of the rights of sovereign states, will be extended to Canada, to Germany, to Japan, to our trading partners.

We have the strange situation that in my State, we will not affect domestic international corporations, multinational corporations, and their activities. They still will be subject to the unitary method of apportionment. It is only those corporations that originate and have their home offices, so to speak, in the United Kingdom that will get this umbrella of protection from State taxation. That discrimination, in my opinion, violates the equal protection concept of our Constitution.

I do not understand why the treaty power should be used by the executive branch in a manner that Congress could not legislate. We, as Congress, could not tell the sovereign states that they could not tax the United Kingdom corporations in this manner but that they could continue to tax those which originate in every other nation of the world.

The net result of the treaty power is to bring about a unique form of tax discrimination. As the Boston Globe points out, it is really taxing State taxation through the use of the treaty power.

I hope the Members of the Senate are not misled by the action taken by our colleagues from California and the Governor of California.

I have a letter from the comptroller of the State of California, dated June 9, in which he states:

Many questions have been raised concerning the contradictory positions taken by the California Franchise Tax Board and Governor Brown as to the Treaty. The Franchise Tax Board is by statute an independent department governed by a three-member board. I, as the Chairman, am also the elected Controller of the State of California.

Another member of the Board is the Chairman of the State Board of Equalization who is also elected by the people of California. The third member is the Director of Finance who is appointed by the Governor.

The Franchise Tax Board is charged with the effective and equitable administration of the California Corporate Franchise and Income Tax Law and the Personal Income Tax Law. The Board's opposition to the treaty is based upon its duty to insure that these taxes are effectively and equitably administered as to all taxpayers.

Our decision in respect to Article 9(4) is based solely on our desire to preserve the integrity of the tax systems of California and other states and to insure that no organization, either foreign or domestic, has an advantage over another due to the structure of the tax system. Passage of the treaty without a reservation as to Article 9(4) would, of course, place U.K. based corporations in a preferred position.

On July 19-20, 1977, I opposed the treaty when it was heard by the Senate Foreign Relations Committee. The California Franchise Tax Board has consistently opposed the treaty—its opposition has never waivered. The enclosure summarizes the department's view as to why state taxes should not be secretly dealt away by the Treasury Department. I or other members of my staff would be happy to discuss with you the reasons why the treaty should not be approved unless Article 9(4) is reserved.

Mr. President. I ask unanimous consent to have printed in the RECORD at the conclusion of my remarks, the letter to which I have referred, together with attachments.

* * *

[p. 18658] Mr. STEVENS. This RECORD should contain our own Budget Office estimate of the cost of the treaty provisions.

The ACTING PRESIDENT pro tempore. The time of the Senator has expired.

Mr. JAVITS. I yield the Senator an additional 5 minutes.

Mr. STEVENS. The Budget Office of Congress indicates that the 1978 revenue loss, not counting those related to ACT and the PRT, is $100 million.

It goes on this analysis to show that in 1983, there will be a loss of $45 million. That is a revenue loss to the United States. It does

not deal with the revenue loss to the individual States. That is what worries me.

What are we going to do? Are we going to find that the United Kingdom now is going to be a haven for corporations that deal with Western States that have the unitary method? Is it going to become the Delaware of the world, where corporations are going to organize so that they can have the impact of this tax haven that the executive branch secretly negotiated away, in violation of the Constitution?

I think the Senate should wake up. This is the first use, to my knowledge, of the treaty power to invade the taxation rights of the sovereign states. It is a foot in the door. The result is going to be — and I hope the Senator from New York is listening — that my State is going to change its taxation methods.

In addition, I hope my State will challenge the constitutionality of this treaty, because I do not think the executive branch should be able to evade the equal protection rights of every corporation that will be discriminated against because of this treaty.

The domestic multinational corporations, the domestic national corporations, and corporations doing business solely in my State will have to bear an increased amount of the burden of taxation because those originating in the U.K. get preferred treatment. It will become literally an island of preference due to the United States-United Kingdom Tax Treaty.

I believe that is wrong. Particularly, I abhor the thought that it is going to happen with respect to corporations coming from our neighbor to the south. It is your neighbor to the north; it is our neighbor to the south. The effect of this will be that corporations coming into my State from Canada will have immunity. They will not face the same kind of apportionment of their worldwide income. They will have advantage over the corporations that come from the State of Washington, for example. Those are foreign corporations to us, in terms of our State law. They are not corporations that originate in Alaska.

This treaty says that foreign multinational corporations coming in from the British Isles cannot be taxed the same way as

corporations are that come from the State of Washington. If the Government follows the procedure that I believe the Senator from New York anticipated — and as I anticipate — that we will extend this kind of haven to corporations originating in Canada, it will mean that the Canadian corporations can come up and to business and bid, and we cannot exclude them. They will come up and do business and outbid the corporations that come from the South 48, to be involved in building such things as Alaska pipelines, drilling for oil and gas, developing our minerals. Then we will give the same haven to those that originate in Japan.

The Senator says we need to attract capital. We need to generate capital within our own country. We have had no problem getting foreign capital to come into my State. The Japanese have been turned down two or three times recently in their bid to buy almost all the hotels in the State. As I pointed out yesterday, they own, as the Senator from Washington knows, more than 50 percent of the shore-based fishing facilities in my State, and the foreign ventures are trying to come in and ruin the impact of our 200-mile limit bill.

EXHIBIT 2

CONTROLLER OF THE
STATE OF CALIFORNIA,
Sacramento, Calif., June 9, 1978.

Hon. TED STEVENS,
Senate Office Building,
Washington, D.C.

DEAR SENATOR STEVENS: Enclosed is a copy of the California Franchise Tax Board's response to the paper furnished you by the Department of Commerce.

Many questions have been raised concerning the contradictory positions taken by the California Franchise Tax Board and Governor Brown as to the Treaty. The Franchise Tax Board is by statute an independent department governed by a three member board. I, as the Chairman, am also the elected Controller of the State of California.

Another member of the Board is Chairman of the State Board of Equalization who is also elected by the people of California. The third member is the Director of Finance who is appointed by the Governor.

The Franchise Tax Board is charged with the effective and equitable administration of the California Corporate Franchise and Income Tax Law and the Personal Income Tax Law. The Board's opposition to the treaty is based upon its duty to insure that these taxes are effectively and equitably administered as to all taxpayers.

Our decision in respect to Article 9(4) is based solely on our desire to preserve the integrity of the tax systems of California and other states and to insure that no organization, either foreign or domestic, has an advantage over another due to the structure of the tax system. Passage of the treaty without a reservation as to Article 9(4) would, of course, place U.K. based corporations in a preferred position.

On July 19-20, 1977, I opposed the treaty when it was heard by the Senate Foreign Relations Committee. The California Franchise Tax Board has consistently opposed the treaty — its opposition has never waivered. The enclosure summarizes the department's views as to why state taxes should not be secretly dealt away by the Treasury Department. I or other members of my staff would be happy to discuss with you the reasons why the treaty should not be approved unless Article 9(4) is reserved.

Sincerely,
KENNETH CORY.

CALIFORNIA FRANCHISE TAX BOARD REBUTTAL OF U.S. DEPARTMENT OF COMMERCE PAPER ON THE U.S. INCOME TAX TREATY WITH THE UNITED KINGDOM

This is a rebuttal to the Department of Commerce April 1978 paper about the supposed benefits of the pending U.S.-U.K. Tax Treaty. That paper contains numerous misstatements of fact and shows an almost complete lack of understanding of the unitary method of computing the income subject to taxation.

The U.S.-U.K. Tax Treaty is the *first* in the nation's history which directly limits the states' most fundamental attribute of sovereignty, i.e., taxing powers. The secretly negotiated treaty has been vigorously supported by the multinational corporations, the Treasury, and, now, the Department of Commerce.

It is difficult to perceive why a very modest state tax on net income would be of such concern to the U.S. Government, unless it fears its archaic method for determining income of multinational corporations will come under Congressional scrutiny, and multinational corporations, like other taxpayers, will be called upon to pay their fair share of taxes. It is even more difficult to understand the apparent great concern shown by the supporters of this treaty for foreign multinational corporations since in practically all cases foreign countries either exempt from taxation the income of their multinational corporations earned outside of their own country or, if income is taxed, a credit is allowed for all foreign taxes paid, both state and national. Thus, when a state is prohibited from determining income of a multinational corporation in a realistic manner one of two things occurs: Either the income is exempt from all income taxes or the country of domicile of foreign corporations receives a subsidy since it will not be required to allow a tax credit.

If the Department of Commerce were truly interested in protecting American businesses it would evaluate the tax privileges multinational corporations now enjoy and determine if they are receiving tax breaks which are not available to local, and to a lesser extent, interstate businesses.

To date, no one, including Congress, has obtained an evaluation of the merits of the separate accounting-unitary concepts from the Internal Revenue Service's auditors who conduct international audits. Although the paper suggests that the unitary concept can result in overtaxation, the plain truth is that overtaxation does not occur. If Congress has any doubt, state and local tax returns of multinational corporations could be subpoenaed and evaluations made as to the amount of income which is in fact reported to the taxing authorities. In fact, Congressman Vanik's yearly analyses of the effective tax rate on multinational corporations show clearly

the multinationals are not paying their fair share of the tax burden.

Any fair discussion of the unitary-separate accounting concepts should include an evaluation of the two methods, including the opportunity under each method for the diversion of income to tax havens, the concealment of income by use of accounting gimmicks, and the ability to affect income merely by changing corporate form. (These subjects are discussed in the Position Paper California filed with the Senate Foreign Relations Committee at its hearing on the treaty on July 19 and 20, 1977. (See Attachment 1, pages 1-9, and Attachment 2, pages 1-12.)

[p. 18659] The "evaluation" in the Commerce study is neither objective nor accurate. It is obvious that those preparing the "evaluation" lacked a substantive understanding of the unitary concept. The nine points made in opposition to the unitary method will now be considered.

1. The Treaty is a "package" that confers on U.S. taxpayers and the 50 states significant benefits which are costly to the United Kingdom. Failure to ratify the treaty complete with those provisions which are beneficial to the U.K. multinationals would place the whole treaty in jeopardy.

Page i of the Summary clearly establishes that most of the benefit for the rebate of the Advanced Corporation Tax (ACT) is for the benefit of United States-based corporations. (1975-78 $245 million and $60 million thereafter. For individuals the rebate for 1973-78 is $136 million with $25 million thereafter.)

The States and California in particular would not benefit from the refund provided for the ACT tax. Most corporations are domiciled in states which do not tax dividend income. Therefore large amounts of such income are currently exempt from tax and the credit given these corporations under the treaty will generate no additional tax for the States. Furthermore when the income of related corporations is included in a combined report and taxed under the unitary method as is the case with California, dividend income is excluded from the tax base. It is the operating results of all the entities which is taxed, not the dividend income which flows between them. Therefore, the additional state tax imposed

on corporations as a result of the rebate of ACT will be minimal. In California's case the only corporations which will pay a greater tax as a result of this credit are those which are domiciled in California and which have United Kingdom subsidiaries which are conducting a business which is unrelated to the general business carried on by the corporation.

As for individuals, there is no information as to where they are located nor is there any information as to the amount of foreign dividend income reported by U.S. investors. Accordingly, the additional state revenue attributable to individuals is at best speculative, and, in any case, of no great significance.

The petroleum revenue tax which the treaty makes creditable will have no impact on the States but will be utilized solely as a reduction of federal income tax.

2. State application of unitary apportionment to the business enterprises of foreign countries is a disruptive factor in the foreign relations of the U.S. Government.

The premise is not acceptable. States, in applying their tax laws to private, profit-making corporations, are not interfering with foreign relations. It is true that since the owners of such companies are near governments in themselves they can immediately bring their concerns to their governments. Undoubtedly many foreign corporations are dismayed when they find their income is determined by a specified formula, and under circumstances where there is no opportunity for back-door dealing. What is involved surely is not a matter of significant foreign policy, it is only the application of a time-tested and judicially approved concept for determining income. What is detested is the simple fact that the unitary concept exposes income to tax in a fair and equitable manner.

The assertion that the states have refused to make any accommodations when foreign governments' complaints have been transmitted is simply not true. The only time a problem with respect to foreign corporations was called to California's attention was in 1968. The problem involved detrimental foreign taxes imposed upon certain U.S. air and shipping corporations because of California's imposition of a tax on the foreign lines. As a result

California added Section 24320 to the California Revenue and Taxation Code, which exempts on a reciprocal basis the income of foreign sea and air carriers.

In the California Franchise Tax Board's view, there is a considerable difference between a problem and protectionism. The Board is willing to approach any problem with an open mind. It, however, applies its laws in an even-handed manner, and does not back off in the application of its laws merely because some multinational corporations are unhappy with the result.

The commentators tipped their hand as to why they want to destroy the unitary concept on page 16 of the report which stated:

> The structure of international tax relations developed between the U.S. Government and the governments of foreign countries has made no provision for this situation, which is new and threatens to spread unless steps are taken to bring State practice into line with standard international tax practice.

Undoubtedly, the unitary concept, which has been used for over fifty years, will spread because it is workable and prevents tax evasion by manipulation of corporate forms. Its use would be greatly accelerated if the U.S. Government would adopt the Treasury Department's staff recommendation of its adoption for federal taxation.

The last paragraph of point two overlooks history. Unlike most governments, our federal government is one which had its powers delegated to it. It does little if any violence in the case of most foreign countries when national governments deal with all taxes. The same cannot be said for the United States because unless the states retain their taxing powers their sovereignty is irrevocably subordinated to whoever for the moment is negotiating treaties for the federal government.

3. The U.S. Government should not engage in or permit a tax practice that if adopted by other countries would be harmful to the U.S. economy. The adoption abroad of the unitary apportionment system of taxing income could be very harmful to the U.S. economy.

It is absurd to conclude that subjecting U.S. corporations abroad to the same taxing systems used by most of the states would cause any significant compliance problems. In reality compliance would be far easier than is now the case if foreign countries could or would subject intercompany transactions to an arm's-length audit. The facts are that foreign countries and the Internal Revenue Service give only lip service to an arm's-length adjustment, and in the very few occasions when an adjustment is proposed, a skilled attorney has no great difficulty in negotiating a favorable settlement.

We are not aware of any leaks of trade secrets by state taxing authorities. The reason is that trade secrets are not required for tax purposes. What is required is financial information of the kind included in reports required by the Securities and Exchange Commission.

The Treasury Department itself has recognized that accounting and translation problems discussed are grossly overstated.

In its justification to support the President's 1978 Tax Program to eliminate the deferral of foreign source income, treasury said, on page 291:

Administrative problems that have been surmountable in these cases will likewise be surmountable when deferral is terminated.

The Commerce paper advances the proposition that use of the unitary method by other countries would prove harmful to U.S. multinationals. This argument perhaps is true with respect to removing the use of tax haven jurisdictions because under a formula method which reflects the activities of a business which actually give rise to income, little or no income would be allocated to paper corporations domiciled in these tax havens. Furthermore, the Commerce Department has completely ignored many of the arguments which are currently advanced against the use of the unitary method by the states. These arguments take the position that the formula results in the over-allocation of income to the states rather than an under-allocation. As long as similar formulas and similar methods are used it is hard to see how this formula which results in an over-allocation of income to the states could also result in an over-allocation of income to foreign countries.

4. Cases of truly unitary operation of related business entities which often make unitary apportionment of multistate business income more practical than a separate accounting of income earned within the State occur much less frequently in the context of multinational business headquartered abroad.

This discussion is a defense of the indefensible. Essentially it is an argument that if we trust the multinationals, their corporate form, and their self-serving accounting records, they will pay the correct amount of tax. California's experience hardly bears out these conclusions. The ease with which corporate accounting records can be manipulated is demonstrated in the Position Paper California filed in connection with the hearings on the treaty. (See Attachment 3, pages 1-26.)

Some of the more recent cases in California currently in litigation involving additional assessments as the result of unitary apportionment and the amounts involved are:

	Million
United States Steel Corporation, filed 5-13-77	\$4.3
Mobil Oil Corporation, filed 6-3-77	12.6
Gulf Oil Corporation, filed 4-6-78	26.4
Alcan Aluminum, filed 4-15-78	1.7

We agree that U.S. state boundaries are irrelevant in the operation of a unitary business. They are equally irrelevant in the case of a multinational corporation regardless of where it is headquartered. All one has to do is go shopping or read the advertisements in any newspaper or magazine to realize that there is truly a worldwide market. For example, who knows where the crude oil was produced that is delivered at the local pumps, or where the various components of any manufactured product were produced? Despite the assertion that a subsidiary paper shield makes an activity separate, such conclusion is merely exalting form over substance.

Although the income assigned by separate accounting records may differ from that determined by an apportionment formula, are the corporate managers or shareholders concerned about which of their various activities is more profitable? Or is their real concern whether the operations in total produce income? An

obvious example of a cost operation which may be vital to the long-range success of a business is research.

Should this activity be isolated or shown as a loss operation even though it develops products which enable a business to grow and prosper?

The Commerce Department paper also fails to realize that the unitary method is a two-way street. In some circumstances the jurisdiction applying the method will increase its revenue, but in other circumstances there will be an actual decrease in the amount of tax assessed by the state. There have been several court cases which demonstrate that this does in fact occur. In California in 1962 two cases were decided, Honolulu Oil Corporation v. Franchise Tax Board, 60 Cal. 2d 417, 386 Pac.2d 40 (1963) and Superior Corporation v. Franchise Tax Board 60 Cal.2d. [p. 18660] 406, 388 Pac2d 33 (1963) which sustained the use of the unitary method when requested by the corporations resulted in a substantial reduction of tax. Recently there has been a decision in Ohio where the Commissioner was required to use the unitary method to compute the income of a corporation doing business within that state. This case involved Beau Brummell Ties, Inc. v. Lindley Ohio Board of Tax Appeals, No. E-1898, March 14, 1978.

The discussion as to invalid apportionment formulas is irrelevant. What is under consideration is not an arbitrary apportionment formula, but one which has been tested by time and repeatedly approved by the United States Supreme Court.

The "arm's-length" method which is so vigorously defended is not workable. In fact, the Internal Revenue Service itself in most cases, according to a noted commentator, uses the unitary concept.

To further demonstrate the unreliability of separate accounting, in January of 1977 Professor Jerome Zeifman, Chief of Staff and General Counsel to the House Judiciary Committee 1973-74, and general counsel to several House subcommittees for fifteen years prior thereto, made a study for the State of Alaska.

In part (p. 24) Professor Zeifman found:

The use by large, vertically-integrated petroleum companies of separate accounting techniques for tax avoidance purposes in Alaska was demonstrated above by Table VIII. In general, this table shows that during 1973, 1974, and 1975, when seven of the largest oil companies operating in Alaska used separate accounting to determine their Alaska taxable income, in no case was any income assigned to Alaska. Instead, each separate accounting was asserted (by the taxpayer) to have demonstrated that the Alaskan operations were being conducted at a loss.

The finding that oil companies are reporting on a separate accounting basis is ridiculous when they themselves describe their business as unitary. See page 1817 of Hearings before the Subcommittee on Antitrust and Monopoly of the Committee on the Judiciary United States Senate Re S. 2387 and Related Bills. In connection with a request for the clarification of financial data, Exxon Corporation said, in part:

As we indicated in our December 16 response and in response to other committees, the FTC's Line of Business and Corporate Patterns reports, and to the FASB's proposal for segment reporting, the petroleum business is unitary in nature.

Finally the Commerce Department study takes the position that the states are applying the unitary method to corporations which are not unitary. Clearly if a foreign corporation or any corporation can demonstrate that its activities do not constitute a single unitary business, that is, that the activities are not interrelated, dependent upon or contribute to each other, than the state tax authorities will not be able to apply the unitary concept. If in fact foreign multinational corporations are less unitary than their United States counterparts, the state tax officials would not be able to apply the unitary concept to them.

5. The unitary apportionment system is difficult to administer and an inaccurate method of apportioning the income of multinational business among taxing jurisdictions.

This discussion demonstrates a lack of understanding of both separate accounting and the unitary concept. Undoubtedly the

cost of a few fungible goods can be determined by separate accounting. However, how is an arm's-length determination made with a patented product, a product based on a trade secret, or any complex finished product? To cite only a few examples: What is the fair market price for a soft drink? a new drug? or an automobile? These, obviously, are only a few of the items that tax administrators must deal with.

The second paragraph beginning on page 24 mentions reasons why the writer thinks a unitary determination is not workable. A cursory reading clearly demonstrates that in activities as described an arms-length determination is impossible. Finally, if the unitary concept is difficult to administer, why the oft-expressed concern that its use may spread?

Turning to the further points.

(A) The Unitary Group:

First, the information required for a unitary computation is far less than would be required if a meaningful arm's-length analysis is made. Next, it is financial information, most of which is in the public realm, which is required, not business secrets.

The fact that some companies have prevailed upon their countries of domicile like Great Britain to pass laws restricting their furnishing financial data should never be accepted as an excuse for allowing a private profit-making corporation from ignoring a state's tax laws. After all, businesses are aware of the state's requirements when they enter.

(B) World Income of the Unitary Group:

It has never been demonstrated that foreign corporations do not have the ability to determine their worldwide income. In many cases their accountants and tax managers have been trained in United States universities, and, of necessity, they follow United States accounting methods for their internal control purposes.

The report seems to assume that the various segments of a unitary business operate in a vacuum. Are we to actually believe that the parent company executives responsible for the worldwide operations of a multinational corporation are not aware of what is going on in their several branches, divisions, and subsidiaries? Are we to further believe that the results of operations are not continuously and instantly available, and in a form which, if made available, would permit the preparation of a combined report?

The exact opposite, of course, is true.

There was a discussion of arbitrary tax assessments. Such are used sparingly, and even then in most cases they are based on published financial information. Also if a business chooses to cooperate, invariably its income and factors can be determined quickly and at minimum expense. If they choose not to cooperate, a provisional assessment is the only alternative.

(C) Apportionment of Taxable Income to the State:

The only substantive complaint about a three-factor formula is that in many cases the income apportioned differs from the income assigned by self-serving accounting records. In many cases, as demonstrated above, the tax change is immense.

Subpoints (1) to (4) attempt to demonstrate the errors of an apportionment formula.

Subpoint (1) suggests that if production takes place in one country and sales in another, there may be a mismatching of income because the profit relationship may vary. This conclusion misses the basic reason for formulary apportionment. As the California District Court of Appeals noted in *Chase Brass & Copper Co.* v. *Franchise Tax Board,* 70 C.A. 457 at 473 (1977):

Generally, Chase's contentions overlook the fact that a unitary business is one in which all parts contribute to the total profits in unmeasurable amounts. Thus, if the profits of any portion of the unitary business are separated from the rest, the base is necessarily inaccurate as the profits from any segment cannot be determined with certainty. (Emphasis added.)

Subpoint (2) suggests wage rates may cause distortion. The United States no longer pays the highest wages. Furthermore, the unitary concept reflects business reality. Under the unitary concept the factors reflect the owner's judgment that manufacturing facilities are located and the wages paid are those which, from a

business standpoint, are the most profitable to it. Also, when fringe benefits of the kind which would constitute taxable income under U.S. concepts are included in the payroll factor, California has yet to find a case where substantial distortion has been documented.

Subpoint (3) suggests that distortion may occur because profit margins differ. This may occur, but it overlooks the fact that if a business activity is unitary, taxing jurisdictions share in the fate of the total unitary business regardless of profit margins as reflected by separate accounting records.

Subpoint (4) repeats the old story of administrative difficulties, but as Treasury itself noted in justifying a portion of the President's tax reform proposals of 1978, these administrative problems are far from insurmountable.

The Commerce Department study suggests that the three-factor formula will reach an unreasonable and unfair result. This is not the case. The courts have recognized for years the fairness of the three-factor formula. Those cases in which they have found a formula to be unfair have usually involved the application of a single formula. Also it should be noted that under the Uniform Division of Income for Tax Purposes Act the state tax commissioner is empowered to exercise his discretion to delete factors from the formula, add additional factors to the formula or to use any other means which is appropriate to fairly reflect a taxpayer's business activities, within the state. Given the discretionary power which state tax commissioners hold under the Uniform Act, a question of unfairness, if it existed under the three-factor formula, would certainly be subject to judicial review.

6. Use of the unitary apportionment method may result in the State taxing income of the multinational enterprise that is not derived from or substantially related to the operations of the enterprise in the taxing State.

The opening paragraph overstates the problem because the unitary income includes only income of a commonly owned business when the operation of a portion of the business done without a state is dependent upon or contributes to the operation

of the business without the state. Thus, common ownership alone is not a basis for unitary apportionment.

The next paragraph simply rejects the realities of a unitary business. It accurately describes certain unitary activities and indicates why there should be no geographical limitations with respect to unitary activities.

In noting the limited application of the treaty, it should be noted that the treaty permits apportionment when branch activities are operated in the U.S. What this means is that if the U.K. parent's operations are unprofitable, business will be conducted through branch operations. If the U.S. operations are unprofitable, business will be conducted through a subsidiary. Therefore, the treaty provides the U.K. corporations with the ability to control their income subject to state tax by the corporate form by which they conduct their activities.

It should also be noted that the authors do not mention that the treaty limitation runs only against U.S. taxing authorities. It is possible that under the language used in the treaty that a U.K. multinational can utilize the unitary concept if it wishes to do so.

It should also be realized that the multinational business may often operate at a loss in a particular jurisdiction in order to obtain a competitive advantage over local businesses. By that means the large multinational corporation can use its income in [p. 18661] our jurisdiction to drive out its competitors in another jurisdiction and in this way discriminate against small business operations. Certainly the charges which have been brought against the Japanese steel companies and television manufacturers involving dumping in the United States' market demonstrate that this is a real threat. While the operations within a particular jurisdiction may actually create a loss, these operations can contribute to the maximum efficient usage of plant and capacity in another jurisdiction which thereby gives rise to the largest overall profit which the business can realize. Only the unitary method deals with these problems in a realistic manner.

As for the unsolicited concern for the States, it is suggested that their business climate and tax policy is a matter of their concern. In fact, there is no empirical evidence which demon-

strates that the business climate of any individual State has been significantly affected by the use of the unitary method of taxation. California, which is perhaps the primary proponent of the unitary method, has consistently ranked as one of the most attractive jurisdictions for foreign businesses.

Furthermore, the unitary system does not, as suggested, tax out-of-State income. It is only a more accurate method for determining income from local sources. If the States were taxing income over which they did not have nexus, such action would be quickly stopped by application of Constitutional principles. Such is not the case: and that is why the multinational corporations are seeking to sneak in through the back door by way of a treaty.

7. Prohibiting States from using the unitary method to tax multinational businesses need not cause the States to lose revenue to which they are legitimately entitled.

The dividend income has been previously discussed. Its impact is minimal. The revenue which is at risk for California (about 10 percent of its corporate base, $125 million as of 1974) is real. The risk is far greater because the treaty will be used as a lever to upset the whole unitary concept. If this occurs, the collective loss to the States will be staggering. As to Section 482, if it cannot be adequately enforced with the Internal Revenue Service with its large and competent staff, is it realistic to assume States with their meager resources and staffs will enjoy any success? The Joint Committee on Internal Revenue Taxation concluded that they would not.

8. The argument that using a tax treaty to address the unitary apportionment problem bypasses the House of Representatives and is an unfair "end run" taken without notice to the States is not supported by the facts.

What this argument overlooks is that the Executive Branch dealt away state taxing powers. It did so without consulting the states, and even without a full awareness of the impact of such action.

The article suggests that the British negotiators have no legal access to Congress. This ignores reality. The tax considerations of

Article 9, Section 4, do not even arise unless there is British corporate activity in the U.S. It is absurd to suggest that persons engaged in business in this country cannot communicate with Congress.

And certainly no such restriction was apparent during the July 20, 1977 Senate Foreign Relations Committee hearing on the treaty when the statement of Mr. John S. Nolan, speaking on behalf of the British National Committee of the International Chamber of Commerce and the Confederation of British Industry, was received by the Committee.

The article also suggests that states are entitled to no more consideration than private interests, even when their powers and revenue are given away. As for the 1973 Senate Hearings, in which California participated, there was no indication whatsoever that California's application of the unitary concept caused concern to the Senators who attended the hearings.

9. Placing limits on State use of unitary apportionment for foreign based enterprises by means of a tax treaty benefits the United States more than achieving this result by Congressional passage of a generally applicable law to the same effect.

The difficulty of a quid pro quo is that the consideration should flow from the principals. The states undoubtedly could negotiate very favorable unitary treaties if they could trade off Federal taxes. It is, of course, an easy bargain when one is trading off rights of another which is not a party to the negotiations.

The principal benefit which results from dealing with the unitary method in a treaty is that it will permanently engraft into the law of the United States a protection for foreign multinational corporations and will make it that much easier for domestic multinationals to obtain the same benefits for themselves under the guise that they are being discriminated against. Clearly this must be the intention of the U.S.-based multinationals or why would they otherwise support a provision in a tax treaty which can only place them at a competitive disadvantage to their foreign counterparts.

Mr. MAGNUSON. Mr. President, will the Senator yield?

Mr. STEVENS. I yield.

Mr. MAGNUSON. This would apply disastrously to our fishing and to our attempt to keep fisheries for American fishermen. They are starting to come in now, and the Senator from Alaska and I have had a difficult time trying to keep them out, have we not?

Mr. STEVENS. We certainly have, I say to the Senator from Washington.

Mr. MAGNUSON. To the jeopardy of American corporations.

Mr. STEVENS. The net result will be that any corporation that comes from the British Isles, from the United Kingdom, and owns vessels that are beyond the 3-mile limit or worse, are within the 3-mile limit, will have a preference over vessels from my State or the Senator's State, and the net effect of it is to bring the foreign vessels closer to our shores.

I do not understand why we cannot have the right to tax as we choose. The courts have held that the unitary method is a fair way to apportion income of multinational corporations.

The PRESIDING OFFICER (Mr. PAUL G. HATFIELD). The Senator's time has expired.

Who yields time?

Mr. JAVITS. I yield 2 additional minutes to the Senator.

Mr. STEVENS. I thank the Senator very much.

I shall end my comments now, and I hope to have comments later.

I will ask the Members of the Senate to look at the record. The record shows that our own Congressional Budget Office shows the loss to the Federal Government of the adoption of this treaty.

The record shows that the national organizations that are involved with tax policy, both those of a public interest nature and those that deal with State legislatures themselves, the attorneys general, the tax commissions of the 50 States, oppose this treaty unless this reservation is adopted.

I just cannot understand why the Senate should feel compelled to approve a secret deal, negotiated by an executive branch, that Congress would be forbidden to do under the Constitution if we were to address this matter with national legislation.

Mr. JAVITS addressed the Chair.

The PRESIDING OFFICER. The Senator from New York.

Mr. JAVITS. I yield myself 5 minutes.

Mr. President, one thing I have learned in the last 10 minutes is the voice of sweet reason does not work, which is what I tried to talk with my colleague about.

Now, I do not want my colleague misrepresenting this to the Senate, because I have been reasonable. For one, what is secret about a treaty signed in 1975 and pending here since then without attention by the Senate.

Mr. STEVENS. Mr. President, will the Senator yield?

Mr. JAVITS. I yield.

Mr. STEVENS. The Senator asked me a question. I hope he will let me answer it.

Mr. JAVITS. I certainly will.

Mr. STEVENS. Not one State was contacted before this deal with the United Kingdom, not one. Our State was never contacted before this treaty was signed. It was released publicly after the deal was signed. We were told exactly the same thing as we were told on the Panama Canal Treaty; that we cannot change it because it will mean it will have to go back to the United Kingdom, for acceptance of a reservation.

I say to the Senator it was a secret deal. My State never knew about it. The executive branch negotiated away our rights without ever contacting us. Every State that looks at it has reacted the same way.

Mr. JAVITS. That is not true, because I just read two letters from two Governors who do not react the same way.

A resolution was presented to the Governors' Conference this very year to go with the Senator from Alaska and disapprove article 9(4). It was not acted on.

Mr. STEVENS. No.

Mr. JAVITS. You could not get the Governors to act on it.

One other thing I wish the Senator to answer —.

Mr. STEVENS. May I answer that first one now?

Mr. JAVITS. All right.

Mr. STEVENS. Who speaks for tax policy for the State? Is it Governor Brown or is it the California Franchise Tax Board? They are duly elected statewide officials, two of them.

Mr. JAVITS. So is the Governor. He is a duly elected statewide official.

Mr. STEVENS. The attorney general enforces the tax laws. The attorney general and the Franchise Tax Board of California. And as a matter of fact, the attorney general of the Senator's State was there at the time the Attorney General of the United States took the position opposed to this treaty.

[p. 18662] Mr. JAVITS. The attorney general of my State is not against this treaty. Is the Senator quoting him? He was there.

Mr. STEVENS. At that meeting.

Mr. JAVITS. The Senator is here now and if he loses does that mean it is wrong?

Mr. STEVENS. He was at that meeting. The attorney general is on record against this treaty.

Mr. JAVITS. So what? Suppose he was at the meeting. Does the Senator quote him?

Mr. STEVENS. Who is he? Who sets the State's tax policy?

Mr. JAVITS. The Governor.

One other thing.

Mr. STEVENS. Ask him why he did not object to this resolution in September.

Mr. JAVITS. I ask my dear friend. Is it now the law in the United States that if you do not object you approve? What kind of jurisprudence or fairness is that? What kind of childishness is that? The fact a Member does not speak here, does that embarrass him when he then votes "nay"? What kind of world are we running?

Now on another point, Mr. President.

Mr. STEVENS. How about the State legislature of the Senator's State? They were at the National Conference of State Legislators; were they not? Where were they?

Mr. JAVITS. Why does the Senator not poll the people and have a plebiscite and take a vote on that of 17½ million New Yorkers?

Mr. STEVENS. If we had had a plebiscite on other treaties, like the Panama Canal Treaty, they would never be ratified. I can tell the Senator that.

Mr. JAVITS. Both Senators of California, have started where the Senator is, have changed, with the Governor.

And one other thing: The Senator is quoting something which I have to challenge and challenge very seriously. He quoted the Congressional Budget Office.

Mr. STEVENS. I put the letter in the RECORD.

Mr. JAVITS. I know the Senator did. I am going to argue from it.

Mr. STEVENS. All right.

Mr. JAVITS. The letter said:

The Congressional Budget Office estimates that the 5-year cost of the treaty provisions other than those related to the ACT and PRT in millions of dollars will be —

Now the ACT is the payback. We are getting over $375 million back, and that is going to be taxed and it is going to be taxed

retroactively, and in addition we are getting $85 million a year which will also be taxed. The Senator did not say anything about those offsets.

Then let us read on from column 1 which says:

Fiscal year 1978 revenues loss, $100 million.

Then it takes a precipitous drop in 1979 to $28 million; in 1980 to $31 million; in 1981 to $35 million; in 1982 to $40 million; and in 1983 to $45 million. If anything it is a washout. With what is coming back under ACT and the other advantages of the treaty it has been enough to convince two-thirds of the Foreign Relations Committee and to bring onto the floor only those Senators, I wish to point out, who represent States that wish to use the unitary tax system.

Now, let me pay my respects to the fisheries and the farmlands and all the other dust that is thrown in the air. As a matter of fact, you can make any tax you please upon any corporation, U.K. corporation, which does business in your community, any tax you please, even confiscatory, unless you are stopped under the Constitution. There is nothing to prevent you from taxing their business for fishing vessels, their business for farmlands, and their property in the State. Under the treaty, the States will not be able, as some have done now under the unitary tax system, to reach out and tax them for property they have and business they do all over the world by an arbitrary proportion of whatever they do in your State, whether there is property there, business, or anything else.

That is the reason why the British and other industrialized nations properly protest against this unitary taxing system.

The United States has negotiated a treaty. It has negotiated many others affecting taxation.

Senator PELL cited one on shipping, reference to which will be found here at page 187 of the record, of the Foreign Relations Committee hearings on the treaty. Our existing Treaty of Friendship, Commerce, and Navigation with France specifically provides that French companies cannot be taxed by our States except with respect to property located in such State, income or property

derived from activities within that State, or business which the French companies do in that State.

That is, in essence, a nondiscrimination article, and we have those in every tax treaty. So there is no discrimination and you are not making a tax haven. You can tax them any way you please, but you have to tax them realistically; you have to tax them on property or business done in that particular State.

Mr. STEVENS. Mr. President, will the Senator yield?

Mr. JAVITS. I will yield in a minute.

The objection which is made by the British, and I think quite a legitimate one to the unitary other taxing system that you use is that it simply reaches out arbitrarily to operations everywhere without regard to what is done in your particular State, and that is unfair.

I yield.

Mr. STEVENS. I hope that the Senator realizes that British Petroleum is one of the owners of the right to develop our North Slope oil and BP is partially owned by the Crown. As a matter of fact, 49 percent of it is owned by the Crown.

Yesterday in answer to my colleague's first comment, the Senator from Idaho distributed to other Members of the Senate a letter which contains this statement.

With regard to its first point about the budget office, Senator CHURCH says:

The Budget Office made no estimate of the potential revenue loss to the U.S. from making creditable, dollar for dollar, against U.S. tax, Britain's Advance Corporation Tax (ACT) or the Petroleum Revenue Tax (PRT). The Revenue Effect section of the Foreign Relations Committee Report on the U.K. Treaty indicates that by making those taxes creditable, the potential loss from the ACT is "somewhere between $50 million and $100 million for the 1975-1978 period, and $15 to $25 million a year thereafter." The potential revenue loss from the PRT ranges between $300 million to $600 million per year by 1983.

Second, let me point out to my friend. I put in the RECORD yesterday the statement published by Exxon throughout the United States from November 1977 through April 1978. That statement was entitled "Let's Talk . . . About 'Equalizing' taxes." The question was asked:

Q. How does the State determine how much of a multistate company's income is taxable in Alaska?

A. Under current law, a multistate or multinational corporation's total worldwide income is apportioned to Alaska by an equally weighted three-factor formula based on the percentage of the company's total property, payroll and sales in the state. For instance, if the company has 25 percent of its total property, payroll and sales in Alaska, the company pays Alaska corporate income taxes on 25 percent of its total federal taxable income — at the corporate tax rate of 9.4 percent. Variations of this same formula are used in 42 other states and the District of Columbia in calculating income to attribute to multistate companies.

Again, let me answer my colleague's inquiry. "Where is the haven?" The haven is that now Exxon will pay that tax but BP will not even though they develop the same oil and gas in Prudhoe, Alaska. Under this treaty BP has a tax haven and it gets it for the quid pro quo of returning those stockholders' impounded funds that the Senator has mentioned.

When you really look at it, what we are doing is we are impeding my State's sovereign rights to tax equally the partners who are developing the Prudhoe gas and oil reserves. The domestic multinational corporations will continue to pay our tax. The foreign United Kingdom multinational corporations, half of it almost owned by the British Government itself, will now have a tax haven and it will have a windfall because it will not be able to be taxed on the same method.

I call the Senator's attention to the fact that resource-producing States that deal with countries such as Japan totally wash out any value of the product that they are developing in the United States. Take timber, for instance; they keep the price of the timber below actual cost as they sell it to their own corporations in Japan. They produce the pulp in Alaska and they sell it to

Japan. We can never get any income tax out of it because they sell it at a loss so what we do is we apportion, based upon their activities in Alaska, their total worldwide income based upon this three-factor formula weighted to property, payrolls, and sales to the State.

That is a very fair method, as a matter of fact, in dealing with the Japanese because they still end up by paying less than if they were a Delaware corporation. I emphasize that — less because they are selling to themselves. Under our system we have to sell at arm's length, and there is a profit factor involved. We are [p. 18663] not dealing as BP is with a Government-owned corporation. I shudder to think what is going to happen if the Senator from New York tells me that ultimately we are going to extend this same privilege to Russia. How are we ever going to deal with Russia?

Mr. JAVITS. The Senator from New York has not told the Senator that.

Mr. STEVENS. We have Russian corporations.

Mr. JAVITS. The Senator from New York has not told the Senator that. Why does he insist on assuming something and setting up a point and then arguing against it? Has the Senator from New York mentioned the Soviet Union in this debate?

Mr. STEVENS. No, I have not said that. I will yield to the Senator if I still have the time.

I say I shudder to think what would happen if the Senator told me that. He told me it is going to Canada. He has told me it is going to go to the United Kingdom. What is going to happen when it goes to a country that deals with a government-owned corporate activity in my State? The Russians do have processing ships off our shores. The Russians are entering into joint ventures with our fishermen. How are we going to tax them fairly as compared to the fishermen who come from the State of Washington?

Again, whether it is Russian or not, will the Senator tell me if this principle is going to be extended to government-owned

foreign corporations anywhere, even including the United Kingdom?

Mr. JAVITS. The Senator is a lawyer and he never answers questions which say, "Have you stopped beating your wife?" The Senator did not mention the Soviet Union and the Senator did not intend to mention Uganda or Burundi or Cambodia. The Senator can call a list of 104 nations and say I did not mention them. What does that prove?

Mr. STEVENS. Let me get to Canada.

Mr. JAVITS. I am going to just answer the Senator.

Mr. STEVENS. The Senator mentioned Canada. Tell me about PetroCan that is owned by the Canadian Government. Can it come into my State with a tax haven if we go to Canada with a similar treaty provision?

Mr. JAVITS. Let us stick to the Soviet Union which the Senator raised.

Mr. STEVENS. The Senator mentioned Canada. I want to talk about government-owned corporations.

Mr. JAVITS. We will get to Canada in a minute. The Senator mentioned the Soviet Union, and that is typical of his argument. He is assuming that the arm's-length tax method is unfair and that is why we need the unitary tax system because the Senator is unwilling to tax—.

Mr. STEVENS. Mr. President—

Mr. JAVITS. If I may just finish — you are unwilling to tax only upon business done or property owned in your State.

And now about Canada. I said, if I may just finish — and by the way we have to stop because of other Members.

Mr. STEVENS. I say to the Senator I think we should quit. I hope he will not let the record stand that I made such a concession.

Mr. JAVITS. OK.

Mr. STEVENS. I will close by saying to the Senator from New York that all of the corporations that originate in New York that come to my State will pay the tax according to the unitary method; all the corporations that come to my State from the United Kingdom will not. Let the Senator explain that to his corporations. I can explain to my State what I am doing.

Mr. JAVITS. I will explain it very well to my corporations, and the quid pro quo was more than worth it. I would like to remind you that Alaska can reach any piece of property or any business done that I wish under a system which is fully allowed to you; and as to Canada, if I may finish, that treaty will be here if it is ever made. If we do not like it, we can turn it down. That goes for treaties with Germany, France, and any other country.

I yield to the Senator from Oregon 5 minutes — I think I had better make it 3.

* * *

Mr. PACKWOOD. I thank the Senator from New York.

I join the Senator from Alaska in opposition to this whole treaty, and especially, 9(4).

This is not a new issue. Several years ago the senior Senator from Georgia (Mr. TALMADGE) introduced a bill that was referred to the Committee on Finance that would have done exactly the same thing in terms of prohibiting the unitary system of taxation that this treaty does.

At my request the Senator from Georgia did not pursue that bill because I told him if it were enacted it would cost the state of Oregon 10 percent of all of its corporate income tax revenue because that bill, of course, would have applied to all corporations, not just from the United Kingdom.

The executive branch, seeing they were not going to be able to pursue their whims through the legislative process and through the committees in both Houses, then attempted to go about it through the back door with this treaty.

I am not saying it is a secret treaty. They just know they cannot get legislation of this nature passed through both Houses of Congress.

What this is going to do, and it is not just the United Kingdom, because if it were just the United Kingdom, it would cost Oregon a very slight amount of money, but this is simply the first in a series of efforts being made by multinational corporations to have Congress extend these treaties to other countries. Example: One of the principal pulp and paper wood industry companies of this country came to me and asked me to support this treaty. I said to them, "Why on earth do you have any interest in this? You do not have any plant in the United Kingdom and I doubt that you have any forestry interests in the United Kingdom or pulp interests."

They said, "Oh, no, of course not. But when it is extended to Canada" — just like that — "when it is extended to Canada, it will mean a great deal to us," and, conversely, will mean a great loss to Oregon.

So I join with the others who object to the U.S. Government trying to tell the State of Oregon we cannot use a unitary method of taxation, one that has been tested in the courts, one that has been tested and found constitutional, one that has been tested and found fair.

Mr. SPARKMAN. Mr. President, will the Senator yield long enough for me to ask for the yeas and nays?

Mr. PACKWOOD. Yes.

Mr. SPARKMAN. Mr. President, I ask for the yeas and nays.

The PRESIDING OFFICER. Is there a sufficient second? There is a sufficient second.

The yeas and nays were ordered.

Mr. JAVITS. Mr. President, does this mean on the vote on the reservation? If not, I ask for the yeas and nays on it also.

The PRESIDING OFFICER. Is there a sufficient second? There is a sufficient second.

The yeas and nays were ordered.

Mr. PACKWOOD. I object to the State of Oregon —

The PRESIDING OFFICER. The Senator's time has expired.

Mr. PACKWOOD. May I finish in 30 seconds?

Mr. JAVITS. I yield the Senator 30 seconds.

Mr. PACKWOOD. I object to the State of Oregon being prevented from using a system of taxation that has been found constitutionally sound, fair, and equitable, that is inexpensive for the State to administer, as opposed to the apportionment method of taxation, where we will have to investigate every corporation that has some business in the State of Oregon.

In conclusion, Mr. President, I seriously object to the executive branch trying to go through the back door via a treaty for what they cannot get through legislation.

* * *

[p. 18664] The PRESIDING OFFICER. Without objection, it is so ordered.

UP RESERVATION NO. EXEC. 41

Mr. KENNEDY. Mr. President, in my statement yesterday, I gave my strong support to the reservation proposed by Senator CHURCH. I also want to associate myself with the able and effective arguments made in favor of the reservation this morning by our distinguished colleague from Alaska, Senator STEVENS. I believe that article 9(4) unfairly deprives the States of a workable and effective method of taxing multinational corporations, and I hope that the reservation will be approved.

Mr. President, in an editorial last Sunday, the Boston Globe strongly endorsed the reservation. I have placed a copy of Senators' desks, and I ask unanimous consent that it may be printed in the RECORD.

There being no objection, the editorial was ordered to be printed in the RECORD, as follows:

[From the Boston Globe, June 15, 1973]
TAXING STATE TAXATION

The advantages of lowering trade barriers and fostering international commerce have been much heralded. So too has the necessity of strengthening the ability of American states to meet the challenges within their borders. Those two objectives have come into conflict in a treaty embodying a U.S.-United Kingdom tax agreement due to come before the Senate soon.

The treaty offers much to American investors — primarily multinationals — that invest in the United Kingdom, including a $375 million tax refund for the years 1973-78 and about $85 million a year thereafter. The refunds would be derived by granting U.S. investors there tax credits to offset the double taxation of business income, as both corporate earnings and dividends, that are now granted British investors in their own country. But while American investors would benefit by the terms of the treaty, American states could suffer.

Embodied in the treaty is a prohibition against states employing a simplified method of deriving the taxes due them from British corporations operating within their borders. Instead, they would be compelled to utilize a cumbersome accounting practice that even with the promised assistance of the U.S. Treasury might be beyond their capacities. There have been wide-ranging estimates of the potential revenue losses to the states. Ultimately, the effect will depend upon whether the United Kingdom accord becomes a model for other U.S. tax treaties with other nations.

But whatever the impact — and Treasury argues that the net result could be an increase in revenues for some states — the effect of the accord would be to embody in a treaty, which neither the states themselves nor their representatives in the House had any role in drafting, a limitation on state taxing policies and prerogatives.

Foreign investors in the United States have every right to demand that they are taxed fairly by the states, that taxing formulas are not jiggered from place to place and time to time. Yet the states clearly have the right to establish their own fair procedures or, at the least, to participate fully if Washington constricts that right.

In light of these considerations, there is a strong movement afoot in the Senate to attach a reservation to the United Kingdom tax treaty voiding the section dealing with state taxing policies. It has the support of Massachusetts tax officials, as well as those in numerous other states, and it is a reasonable course.

Mr. KENNEDY. Mr. President, there remain 3 minutes under the consent agreement before we vote on the reservation. What I intend to do now is ask unanimous consent that the pending reservation may be temporarily laid aside, so that I may call up and dispose of briefly my reservation to article 23. We can probably dispose of this reservation in a few minutes, and I am confident that we can avoid the rollcall rote scheduled on it under the consent agreement.

* * *

[p. 18665] ● Mr. CHURCH. Mr. President, I requested Jerome M. Zeifman, professor of law at the University of Santa Clara, Calif., and director of the National Institute of Law and Economics, to comment on the proposed U.K. Tax Treaty and in particular on article 9(4). Professor Zeifman served as chief of staff and general counsel of the House Judiciary Committee, and as chief counsel of the Subcommittee on State Taxation of Interstate Commerce. He has also been a consultant to the State of Alaska on the taxation of multinational petroleum companies and conducted an investigation for that State of the application of the corporate income tax.

He specifically notes that article 9(4) of the U.K. Treaty "embodies a tax policy which is inconsistent with the unanimous findings and recommendations of the House Judiciary Committee." Further, he states that the support material prepared by both the Treasury and Department of Commerce "totally ignores the fact that the House Judiciary Committee recommended that a separate accounting system of taxation based on an arms-length standard be entirely prohibited for State tax purposes. This recommendation by the House Judiciary Committee was based on a unanimous finding that separate accounting was an arbitrary and unworkable method and was beyond the capacity of the States to enforce."

Professor Zeifman points out that article 9(4) should have no effect in encouraging U.K. investment in the United States because under the laws of the United Kingdom, British corporations operating enterprises in the States of the United States are permitted a full credit against the U.K. tax for income taxes paid to the States as well as income taxes to the U.S. Government.

I ask that Professor Zeifman's letter to me, an interview with Professor Zeifman in the publication TaxBACKTalk, and an analysis he prepared entitled "The Taxation by California of the Income of Multi-National Corporations," be printed in the RECORD.

The material follows:

THE UNIVERSITY OF SANTA CLARA,
June 15, 1978.

Senator FRANK CHURCH,
Committee on Foreign Relations,
U.S. Senate,
Washington, D.C.

DEAR SENATOR CHURCH: I have your letter of June 2nd, 1978 concerning the proposed United Kingdom Tax Treaty, and appreciate your concern with Article 9(4) which would prohibit our states from employing a "unitary" method to determine the taxable income of a United States enterprise controlled by a United Kingdom corporation.

As you know, during my years of service as Chief of Staff and General Counsel of the House Judiciary Committee, and as Chief Counsel of the Subcommittee on State Taxation of Interstate Commerce. I had the opportunity to investigate the corporate income tax systems of all of the states in great depth. After leaving the House Judiciary Committee in 1975 I became a Professor of Law at the University of Santa Clara, where I regularly teach a course in State and Local Taxation. In 1975 I also became a consultant to the State of Alaska on the taxation of multinational petroleum companies and conducted an investigation for that State of the application of the corporate income tax in particular. In providing you with my personal views on the

proposed treaty, I am pleased to have the opportunity to draw on these past experiences.

At the outset, let me express my dismay in observing that Article 9(4) of the proposed treaty embodies a tax policy which is inconsistent with the unanimous findings and recommendations of the House Judiciary Committee and which were set forth in that Committee's "Report of the Special Subcommittee on State Taxation of the Interstate Commerce." In that regard, it is especially noteworthy that the material supporting the treaty prepared both by Treasury and by the United States Department of Commerce, totally ignores the fact that the House Judiciary Committee recommended that a separate accounting system of taxation based on an arms-length standard be entirely prohibited for State tax purposes. This recommendation by the House Judiciary Committee was based on a unanimous finding that separate accounting was an arbitrary and unworkable method and was beyond the capacity of the States to enforce.

During the seven-year period from 1961 to 1968 when the House Judiciary Committee was actively concerned with these issues, many of the world's largest multinational corporations, which are now members of the Committee on State Taxation of the Council of State Chambers of Commerce, lobbied vigorously for federal legislation prohibiting the unitary method and requiring the states to use separate accountings. Since the Judiciary Committee totally resisted those efforts, and instead endorsed the unitary method, serious doubts now arise as to the appropriateness of the treaty device being used in a manner that places the states at the mercy of multinational corporations.

In more recent years, I have had occasion again to reexamine and reevaluate the findings and recommendations of the House Judiciary Committee. As part of my investigation on behalf of the State of Alaska in 1975, I examined the income tax liability of the thirteen largest petroleum companies operating in that State. I ascertained that during the period 1973 through 1975 seven of those companies operating in Alaska used separate accounting to determine their Alaska taxable income, and that in not one of those cases was any income assigned by those companies to Alaska for tax purposes. Instead, each separate accounting was

asserted by the multinational corporation to have demonstrated that the Alaskan operations [p. 18666] were being conducted at a loss. Under the circumstances, it seems clear to me that because of its arbitrary nature, the use of separate accounting by large multinational corporations affords those corporations the opportunity for wide-scale tax avoidance. The findings in Alaska are set forth on page 42 of the enclosed report which was prepared by me and Professor Kenneth Ainsworth for the Alaska Legislature and the Alaska Department of Revenue.

In evaluating the effects of the proposed treaty, let me urge that the Senate not only consider the fact that separate accounting is an unworkable and undesirable tax policy for the states, but that it also embodies administrative policies which have an enormous potential for political corruption. Since, in many cases, there are in fact no arms-length transactions which can be used as an administrative standard, both the tax administrator and the taxpayer are afforded the opportunity to use unbridled discretion in determining the taxpayer's ultimate liability. At the same time, since tax returns are shrouded in confidentiality, no adequate devices are available to assure that individual corporations are in fact required to pay their fair share of tax. For this reason alone I strongly urge that the Senate reject Article 9(4).

In further evaluating the material prepared by Treasury and the Department of Commerce, I believe it is also noteworthy that under the laws of the United Kingdom, British corporations operating enterprises in States of the United States are permitted a full credit against the United Kingdom's tax for income taxes paid to the States as well as income taxes paid to the United States Government. Under the circumstances, the unitary system of taxation currently employed by the states does not increase or affect the ultimate tax liability of British corporations. As a result, Article 9(4) ought properly to have no effect in encouraging British investments in the United States. That being the case, a principal argument in favor of the treaty is obviously totally without merit.

In closing, let me again thank you for the opportunity to present my views concerning these important matters. I recognize that a more detailed and more technical analysis of Article 9(4) than is

possible in this brief letter might be of further assistance. As a result, I am also enclosing an analysis which I prepared for the California Tax Reform Association as well as the Alaska study and a copy of my prepared testimony at a recent hearing of the California Assembly Committee on Revenue and Taxation.

If I can be of further assistance, please let me know.

Sincerely,
JEROME M. ZEIFMAN,
Professor of Law.

TAXING MULTINATIONALS — A CTRA FOUNDATION ANALYSIS

For some time, state and federal legislators and government officials have been considering changes in the system of taxing multinational corporations. At issue is whether or not these companies should be taxed on a percentage of their worldwide profits (the "unitary" method), or only on the profits of their subsidiaries in any given state.

On the federal level, the Senate Foreign Relations Committee last fall considered a treaty between the U.S. and the United Kingdom which would prohibit states from using the unitary method in taxing British-based multinationals, but indefinitely delayed acting on the treaty.

Governor Brown, once a supporter of the unitary method, now proposes to abolish it in California for all foreign-based conglomerates not engaged in the energy business. The Brown turnabout coincided with reports that the major impediment to Japanese corporate expansion in California is the unitary method.

In an effort to answer some basic questions about the unitary method as opposed to alternative "separate accounting" methods of taxation, TaxBackTalk recently interviewed Jerome M. Zeifman, Professor of Law at the University of Santa Clara.

Zeifman served as Chief of Staff and General Counsel to the House Judiciary Committee in 1973-74, and as general counsel to several House subcommittees in the past 15 years. In 1975 he was

consultant to the State of Alaska on taxation of multinational petroleum companies.

TaxBackTalk: Professor Zeifman, there is currently a great deal of discussion and debate regarding multi-corporate income taxation in California. What do you feel the real issues are in this debate?

Zeifman: The broad ramifications of this subject have something to do with antitrust laws. It is interesting to me that the California Franchise Tax Board is one of the few bodies in the world that looks at multinational corporations in terms of the whole picture—though one of the things that the multinational firms have been successful in doing is to divide the world's governments and conquer them.

There is no regulatory body that regulates multinational corporations as the single entities which they really are, in an economic sense. Because of the multi-corporate form of multinational corporations there has developed in the tax field widespread interjurisdictional loopholes. As a result, those of us who live almost totally within one jurisdiction end up being taxed on 100 per cent of our incomes. Whereas the multijurisdictional corporations, through these loopholes, are able to avoid paying their fair share. We pay more and more; they pay less and less.

TBT: What does the unitary apportionment approach to corporate income taxation mean in contrast to the "separate accounting" approach?

Zeifman: By applying the unitary apportionment method of corporate taxation, the Franchise Tax Board assesses the net taxable income of Mobil or Exxon or General Motors based on the percentage of the company's property, payroll or sales in California. Hence, it treats each of these companies, with its many subsidiaries, as a single business for tax purposes. Taxable income is determined by multiplying the taxpayer's entire income by a fraction which is the average of the ratios of California-to-total property, payroll and sales.

Under a system of separate accounting tax liability is determined by each taxpayer assessing its own level of profitability for each of its operating units in the state.

TBT: What do you feel the effect will be upon corporate tax receipts of abandoning the unitary approach and adopting an "arm's length" method of determining tax liability.

Zeifman: In order to conduct a proper audit based on separate accounting when you are dealing with companies the size of Mobil Oil, General Motors, Eastman Kodak or Sony, in theory, all intercorporate transactions have to be examined and be computed on an "arms length" basis. This means that if a Japanese corporation charged its subsidiary in California five million dollars for certain services, separate accounting would compel the tax administrator to determine how much the California subsidiary would pay for these services in an open market in which there was free competition.

In the world of multinational corporations there is no arms length market price available, especially on large-dollar items. The tax administration is forced to engage in the most expensive and burdensome type of audit, the so-called cost accounting analysis of all the corporation's services. I don't believe that the state is capable of conducting an adequate cost accounting of Mobil Oil and its worldwide operations.

To undo the unitary method with respect to multinational corporations would result in substantially limiting the state's power to effectively raise revenue in the corporate income tax area for multinational corporations. In my view, for California to return to a non-unitary method of taxation would be, in the state tax field, a return to the stone age of taxation

TBT: Specifically, what is the major problem with the separate accounting method?

Zeifman: The separate accounting method allows each multinational corporation to determine for itself, based on its own separate accounting, the level of profitability for each of its California subsidiaries. This is, therefore, an artificial level of profitability. In brief, it would be easily possible for a corporation

based in New York, or Japan or England, through easily arranged intercorporation transfers, to charge the California subsidiary a higher price for its services, arrange such things as intercorporate loans, so there would be a low level of income based on the separate accounts. In some cases the creation of artificial losses with respect to the California operation could be arranged.

TBT: How does the unitary approach amend that problem?

Zeifman: The unitary approach avoids what I call the "corporate shell game," which exists so long as we allow each corporation to operate under its own shell for tax purposes. The unitary approach simply corresponds to economic reality. I would argue that Mobil Oil, for example, is and ought to be viewed as a single unitary type of operation. It is really one business. Any kind of multicorporate firm, subsidairies and affiliates, which are controlled by a single parent firm or holding corporation ought to be viewed as a single economic entity for tax purposes.

TBT: If California were to abandon the unitary approach, what do you feel the effect would be upon individual taxpayers and small businesses in the state?

Zeifman: The more the state engages in tax giveaway programs, and the more the state engages in eroding its own revenue base with respect to multinational corporations the more the burdens of supporting state government are shifted to individuals who are taxed entirely. Relatively small-sized businesses which do not have the advantage of operating across state lines are in the same boat. So, in a sense, the Brown proposal to at least partially abolish the unitary method is a way of offering gigantic tax subsidies to non-California businesses and individual taxpayers.

TBT: How do you respond to the claim that the unitary approach causes double taxation?

Zeifman: When the FTB applies a unitary approach to a corporation like Mobil it is not purporting to tax Mobil's non-California income. All the FTB is saying is that it regards Mobil as a single business and in determining how much of its income is to be attributed to California for tax purposes the FTB will look at the whole picture and determine how much of Mobil's property,

payroll and sales are in California as compared to its worldwide property, payroll and sales.

There is a widely-used device in the law called "piercing the corporate veil:" looking behind corporate shells and asking who really owns the corporation. The unitary approach is simply one which says we are not going to tax corporations on the basis of mere corporate shells. We are going to look at the whole picture and look behind the corporate veil.

TBT: What do you think of the current [p. 18667] apportionment method of unitary taxation in California, and how would you change it —

Zeifman: If I have a criticism of the California unitary system, it is that it is not unitary enough because the unitary method has historically evolved, to a large extent through the courts. The legislature has never fully addressed itself to the subject.

Under the decisions of the California Supreme Court the unitary method is applied on the basis of a threefold test. The Courts look for a "unity of ownership, unity of operation and unity of management." Thus, it is possible under the judicial test for one corporation to have a wholly owned subsidiary which would not be unitary under the court's test. In this case the Franchise Tax Board would be required to make a determination as to what piece of the California subsidiary was unitary with the parent. That requires an exercise with a certain amount of administrative discretion.

I advocate taking the approach which the House Judiciary Committee took some years ago: lay down a rule that says if there is more than 50 per cent common ownership, affiliated corporations would be treated as unitary.

I would recommend to the California legislature, as I did in Alaska, that the test for unitariness be prescribed by statute simply to be one of common ownership and control.

TBT: It has been said that reverting to separate accounting opens the way for excessive administrative discretion and possible corruption. Could you comment on this observation?

Zeifman: I would be the last one to ever level the charge of corruption against the California Franchise Tax Board, and I am not saying that the undoing of the unitary tax would corrupt the FTB. However, I would regard the undoing of the unitary method as a corrupting force on tax administration in general. The use of a separate accounting method of taxation allows for an enormous amount of discretion to be exercised by both the tax administrator and the taxpayer in determining what the income subject to the tax will be.

I think it goes without saying that unbridled administrative discretion has a potential for corruption. What can make the system even more corrupt is that, in the income tax area, because of a view which is widespread in the U.S. that income tax returns are sacrosanct and shrouded with confidentiality, we now have the two cancer-producing elements in government: unbridled administrative discretion coupled with secrecy.

One thing which adversely affects the business climate is that if a tax administrator is able to exercise unbridled discretion in secret, then even though he treats me fairly, I have no way of knowing whether he has bestowed upon you any special benefits which have not been made available to me. That is not an atmosphere in which to run a railroad.

Politically in this state, I see a movement afoot to remove some of the independence of the Tax Board. Hence I would add to my observations about corruption in government a third cancer-producing element which is the politicization of law enforcement. A system based on discretion, in secret, lends itself to politicization.

Although I am sympathetic to the Governor's concern for getting companies to move to California, when a connection exists between the tax administration or any law enforcement agency and the political fortunes of the governor then the tendency would be to favor those corporations in a manner which would be most favorable to the governor's fortunes, and to correspondingly hit harder at those companies which were adverse to the governor. The separate accounting system fosters this unhealthy connection.

The Taxation by California of the Income of Multi-National Corporations

(By Jerome M. Zeifman)

Mr. Chairman and distinguished members of the Committee on Revenue and Taxation, let me first express my appreciation for giving me the opportunity to share m views on the taxation by California of the income of multi-national corporations.

More than ten years ago I appeared before this same Committee in a different capacity. At that time I was a resident of the District of Columbia and was Counsel to the Sub-committee on State Taxation of the Judiciary Committee of the United States House of Representatives. The Subcommittee, had conducted a comprehensive investigation of the taxing systems of California and of each of the other forty-nine states. I appeared here in California as a spokesman for that Subcommittee, which was then called the "Willia" Subcommittee and later became known as the "Rodino" Subcommittee.

Today I am pleased to be here in a different capacity. I recently resigned my position as Chief of Staff and General Counsel of the House Judiciary Committee and have become a Professor of Law at the University of Santa Clara. Since I now enjoy the benefits and privileges of being a new Californian I am delighted to present my views simply as a fellow resident and fellow taxpayer.

Although I have only recently become a taxpayer my associations with "the California Franchise Tax Board now go back to 1961 when the House Judiciary Committee first began our investigation of that agency. Since that time I have also participated in a wide variety of other investigations of government agencies and government officials conducted by the Judiciary Committee of the Congress. I am especially pleased to tell you today that there is no government agency, federal or state, for which I have a higher regard than for the California Franchise Tax Board.

It is because I believe that both the effectiveness and integrity of the Franchise Tax Board will be greatly impaired, if not destroyed, by the legislation before you that I would like to urge you to reject any proposal which would undo the present unitary

method of taxing foreign and multi-national corporations. Expressed conversely, let me also urge you to reject any proposal which permits any foreign corporation to use a separate accounting method of taxation under circumstances in which separate accounting is currently prohibited.

My support for the unitary concept and opposition to separate accounting falls into three inter-related areas which I would like to review for you briefly.

First, as the courts have long recognized, affiliated corporations which are commonly owned and managed, and which engage in a common enterprise, should be treated as a unitary enterprise for tax purposes. To do otherwise would do violence to economic reality and permit the inequitable distribution of tax burdens. In this regard it is especially noteworthy that not only the Supreme Court of California but the Supreme Court of the United States has for a number of years now been rejecting the use of separate accounting in favor of the unitary approach.

Second, the use of separate accounting would permit multinational corporations to engage in wide scale tax avoidance schemes which would be beyond the capacity of the state to control The inevitable results would be inestimable losses of revenue. This is because the separate accounting method would allow the foreign corporation to determine for itself, based on its own separate accounting, the level of profitability for tax purposes of its California subsidiaries.

In brief, it would be easily possible for a corporation based outside of California to charge the California subsidiary a higher price for its services and a higher price for products, and to arrange such things as intercorporate loans, all in such a way that there would be a low level of taxable income attributed to California.

With respect to the tax avoidance aspects of separate accounting, let me call to your attention, for example, the recent investigation which I conducted for the State of Alaska last year. My investigations revealed that, in the case of the thirteen largest petroleum companies operating in Alaska, whenever a tax return was filed with the state on a separate accounting basis, the

corporation reported no income whatsoever to the State for tax purposes. In this regard, let me further point out that any revenue losses to the State of California engendered by the use of separate accounting, would presumably have to be made up through the taxation of local corporations and local businesses which are located wholly within the state.

Third, under a separate accounting system of taxation, the enforcement of the franchise tax would be so severely impaired as to be in serious danger of being exposed to extreme politicization, or corruption, or both. This is because the use of separate accounting method of taxation allows for an enormous amount of discretion to be exercised by both the tax administrator and the taxpayer in determining what the income subject to tax will be. In theory, for example, all intercorporate transactions have to be examined and recomputed on a so-called "arms length" basis. Yet, in the world of multinational corporations, there is in fact often no arms length market price available which the administrator is able to use as a standard. The administrator is thus left almost entirely to the exercise of his discretion.

Mr. Chairman, and members of this Committee, I believe that each of the three reasons I have cited for opposing the use of separate accounting ought in itself to suffice as a grounds for rejecting the legislation before you, but in closing let me give special emphasis to the matter of the use of broad administrative discretion in a taxing system. I think it goes without saying the unbridled administrative discretion has a potential for corruption. At the same time, it is important to note that when we talk of the exercise of administrative discretion in the income tax area, we must also consider the fact that we are dealing with government powers that are exercised in secret, since income tax returns and income tax audits are shielded from public view. Thus, we are now dealing with two cancer-producing elements in government: unbridled administrative discretion coupled with secrecy.

Under the circumstances, since separate accounting is both a bad tax policy and embodies the worst features of bad government as taxpayer and a citizen I would like to urge you to reject the proposals before you in their entirety. ●

● Mr. DOLE, Mr. President, the pending tax treaty for the United Kingdom has generated a great deal of controversy. It has been almost a year since the Senate Foreign Relations Committee held hearings on the treaty and it has been several months since the committee reported the treaty to the full Senate.

Mr. President, our economic and social relations with the United Kingdom are close and extensive. At the present time the United States has over $14 billion in direct investment in the United Kingdom. Over $1 billion in dividends, interest, and royalties from this investment is received by U.S. investors every year.

[p. 18668] ARTICLE 9(4)

Most of the controversy about the United States-United Kingdom Tax Treaty has been generated by article 9(4) of the treaty. Article 9(4) provides that States will not tax the income of a United Kingdom corporation, determined by treaty standards, which is controlled by United Kingdom residents and is not now doing business in the United States. The treaty contemplates, however, that the States would enforce, with Federal cooperation, on arms length standards of all intercompany transactions to assure that no income properly attributable to a State could escape State tax. States that employ the unitary tax system such as California and Alaska have been strong opponents of this treaty. However, it is interesting to note that both the Senators from California and the Governors are supporting treaty ratification.

U.S. FARMLAND

In addition, treaty opponents state that the Treasury of the United States will lose millions of dollars in revenue. There have been charges that the treaty discriminates against individuals and will have an adverse effect on the capital and securities market in the United States. There have been some farm groups which believe that the United States-United Kingdom Tax Treaty will send the price of U.S. farmland skyrocketing.

Mr. President, I am concerned as much as any Senator in this Chamber about the effect of this treaty on U.S. farmland. However, I can find no supportable evidence that the proposed treaty would create a tax preference of foreign owned farmland and prevent States from regulating the ownership of farmland.

ADMINISTRATION RESPONSE

Mr. President, when the Senator from Kansas heard the charges that the treaty would have an adverse effect on our agricultural industry, I inquired at the Department of Treasury to specifically address this point. Subsequently, I believe all Senators have received a letter from Donald C. Lubick, Assistant Secretary-Designate for Tax Policy. In the case of the United States-United Kingdom Tax Treaty I am inclined to support the administration. I shall ask that a copy of the letter be inserted in the RECORD following my remarks.

Mr. President, the United States-United Kingdom Tax Treaty obligates the United Kingdom to make substantial refunds of taxes estimated to be near $400 million to American investors in the United Kingdom corporations. The transfer of this amount of money, from a foreign country to the United States can only be beneficial when our balance of payments is running at a severe deficit. The transfer of this money could help the value of the dollar in foreign currency markets.

Mr. President, proponents of the treaty have charged that the treaty is usurping the prerogative of the Congress to legislate. As a member of the Senate Finance Committee dealing with tax matters I find the treaty appropriate, in this instance, to settle this matter.

Mr. President, the controversy over article 9(4) has been the subject of considerable misunderstanding. From the viewpoint of the United States, article 9(4) represents a relatively minor concession in relation to the overall benefits of the treaty. The Senator for Kansas believes the treaty restriction on the so-called unitary tax system will not have a serious impact on State revenue if there is any adverse impact at all. There is a reasonable basis to believe that the other parts of the treaty, especially those requiring

repatriation of money to the United States will in fact, increase State revenues.

My decision about the United States — United Kingdom Tax Treaty has not come easy. It is my judgment that the ratification of the treaty without the Church reservation is in the best interest of the United States. This does not mean that I will automatically support the ratification of similar treaties. The Senator from Kansas believes that each subsequent treaty must be individually examined and assessed.

The letter follows:

DEPARTMENT OF THE TREASURY,
Washington, D.C., May 3, 1978.

Hon. ROBERT DOLE,
U.S. Senate,
Washington, D.C.

DEAR SENATOR DOLE: The Senate will soon consider a proposed new income tax treaty between the United States and the United Kingdom; Secretary Blumenthal has just written you urging you to vote for the treaty and explaining its benefits to the United States. Since that letter was written it has come to our attention that two new and related arguments are being made against the proposed treaty — that the proposed treaty would create a tax preference for foreign owned farmland and prevent states from regulating the ownership of farmland. As I explain below, both arguments are unfounded.

The proposed treaty does not in any way create a tax preference for foreign ownership of U.S. farmland. The proposed treaty contains no provisions specifically addressed to the taxation of farmland. The treaty does provide in Article 6 that all U.S. real property income is taxable in the United States under normal Federal tax rules. This would include income derived from farmland. The treaty most certainly would not prevent the states from taxing farm income.

As explained in Secretary Blumenthal's letter, there are a few limited situations where pursuant to Article 9(4) of the proposed

treaty states may not use the so-called unitary method in taxing profits. At the present, there are only three states that would be affected by Article 9(4) — California. Alaska and Oregon. In the limited situations where the unitary method of taxation may not be used, the states are allowed under the treaty to use the arm's length method of controlling prices in transactions between related parties. There is a wide market for agricultural products and it is, therefor, very easy to obtain arm's length prices and to avoid any possible shifting of profits. Moreover, Federal audit information is available to state tax authorities for the purpose of determining an arm's length price.

We understand that the concern with respect to the taxation of farming profits is primarily directed at Japanese interests and not the United Kingdom. Of course, the proposed treaty with the United Kingdom does not in any way relate to Japanese investment.

Another argument with respect to the treaty's impact on farmland is that the treaty would somehow prevent the states from requiring that farmland be owned by domestic corporations or domestic persons. This argument is totally incorrect. The proposed treaty does not contain any rules affecting state laws with respect to the rights of foreign persons to own U.S. farmland or any other type of land. Although there is a non-discrimination article in the proposed treaty is this article only applies to Federal and state laws with respect to taxation. The non-discrimination article in the proposed treaty is the same in this respect as non-discrimination articles already contained in our current treaty with the United Kingdom and sixteen other U.S. tax treaties. None of those treaties require the states to alter any rules with respect to land ownership.

I hope that this letter eases any concern you might have had about the farmland question. I would be pleased if you would share the contents of this letter with those of your colleagues who are concerned about this issue.

Sincerely,

DONALD C. LUBICK,
Assistant Secretary — Designate
(Tax Policy).●

● Mr. GLENN. Mr.President, I wish to add my support for the United States-United Kingdom Tax Treaty which the Senate is presently debating.

The proposed tax treaty with the United Kingdom contains certain provisions which would be highly beneficial to U.S. based corporate and individual investors. The most significant of these provisions is the refund to U.S. investors of the U.K. advance corporation tax (ACT). The United Kingdom has eliminated double taxation by taxing corporate profits only at the corporate level. A portion of the tax collected at the corporate level is refunded to U.K. shareholders in order to satisfy the shareholder's tax liability on the dividend distribution. Under the tax treaty, U.S. shareholders would also receive this credit so as to put them on an equal footing with the U.K. shareholders. U.S. portfolio investors, those owning less than 10 percent of the U.K. corporation, would be refunded the full ACT. U.S. direct investors, those owning 10 percent or more of the U.K. corporation, would only get a 50-percent U.K. ACT refund but would receive a U.S. foreign tax credit for the nonrefunded portion.

Including U.S. shareholders within the United Kingdom integrated tax system would eliminate the inequitable situation which presently exists. The U.S. Treasury Department believes that combining the U.S. tax system with the integrated U.K. system is a significant step which could provide a precedent in the development of future tax treaties with other countries which also use the integrated tax system. Estimates are that ACT refunds, to be made retroactive, would total $375 million initially to U.S. investors in U.K. companies and amount to approximately $85 million annually thereafter.

Another significant provision in the proposed treaty would remove a disincentive which presently exists to further U.K. investments in the United States. Section 9(4) would restrict the ability of a State to use the unitary apportionment method in assessing the State income tax [p. 18669] liability of a U.K. corporation or one which is controlled by a U.K. corporation. The unitary method of taxation is a means by which several States determine corporate income for purposes of taxation by calculating the percentage of the corporation's worldwide income which

can be apportioned to the State. The controversial feature of the unitary method is the extraterritoriality of its scope. The apportionment calculation is applied not simply to the corporation which is doing business within the State, but also to affiliated corporations which may not be doing any business in the State or in the United States for that matter. This extension of State taxing power through the unitary method to foreign corporations not doing business in the State or in the United States could subject them to double taxation, and, therefore, has caused concern.

Section 9(4) would constitute only a minor limitation on State taxing power while reassuring U.K. corporations that the United States has a favorable investment climate by restricting the application of an undesirable taxing method. Moreover, concern has been expressed that if a reservation is applied to section 9(4) of the treaty it is likely that the United Kingdom will seek to renegotiate the treaty and the favorable ACT refunding provision may be substantially modified or lost.

During the Senate Foreign Relation Committee consideration of the United States-United Kingdom Tax Treaty, I opposed a reservation to section 9(4) and voted in favor of reporting the bill, as proposed, to the full Senate. I intend to maintain my support for the treaty including section 9(4) during the present Senate consideration.●

CALIFORNIA AND THE U.S.-U.K. TAX TREATY

● Mr. CRANSTON. Mr. President, the effect of the United States-United Kingdom Tax Treaty on the finances of the State of California has been widely discussed both in my State and in the Senate.

It has been urged upon me by a number of persons that I reconsider my stand in support of the treaty in the light of the passage of proposition 13.

My answer has been and continues to be to support the treaty without reservation to article 9(4).

Now more than ever California needs more revenues and the U.K. Tax Treaty is an opportunity to increase State income not by raising taxes, but by attracting more businesses to the State.

California's economy last year out-performed that of every one of the 15-leading industrial States — including all the States of the Southwest Sun Belt — by adding new jobs at a rate faster than the rate of expansion of the labor force. My State must continue that high level of economic performance if we are to meet the expectations of the more than 22 million Californians and the thousands of new daily arrivals many of whom seek to find work in California.

Few in the East are aware that California has replaced New York as the principal destination of immigrants to this country. Over 1 million aliens admitted for permanent residence live in California. Many undocumented workers live and work in our State contributing both to the strength of our economy and, unwittingly, to the potential for social conflict.

Only a highly productive and expanding company can successfully sustain the rapidly growing population of California.

On balance, I feel that ratification of the United States-United Kingdom Tax Treaty will produce substantial economic benefits for California and for the Nation.

Mr. President, it has been stated frequently on the floor of the Senate that the treaty will cost California over $125 million in lost revenues due to the limitations prescribed on the unitary tax method of assessing the corporate income tax. Some have claimed the figure "would be at least $150 million."

Mr. President, last night Governor Brown's Secretary of Business and Transportation Richard Silberman totally refuted these outsized claims of revenue loss to the State. Mr. Silberman reports that a study done for Governor Brown by the State Franchise Tax Board, under the direction of its Executive Director, Martin Huff, places the revenue loss at $10 million and not more than $15 million.

Mr. President, $10 million is a lot of money. But it is far off the mark of the $125 million and $150 million figures so casually quoted on the floor of the Senate.

In addition, the $10 million would be a barely measureable impact on the more than $1.8 billion in corporate taxes collected by the State.

The limitation imposed on California by article 9(4) simply requires that the State not apply the unitary tax method so as to tax the income of non-California related operations of the United Kingdom parent corporation.

That is an eminently fair principle of taxation and I support it.

The California Franchise Tax Board is the most efficient tax collection agency of any State. Politically, the board is more independent than the IRS. As a former Comptroller of the State of California, I have profound respect for the integrity and ability of the board and its employees. The amount of money involved in the corporate income tax collections by California substantial and well worth the effort of the board to levy and collect. I have great confidence that the franchise tax board will be as effective under article 9(4) in collecting revenues from U.K. subsidiaries as the board is today without the treaty.

The treaty deserves support and ratification. It is good policy for both California and the Nation.●

Mr. MATSUNAGA. Mr. President, both the proponents and opponents of the Church reservation have forcefully presented their views.

At first I was inclined to vote against the Church reservation, but after deeper consideration of all the implications of article 9(4), I am convinced that the Church reservation deserves the support of every Member of the legislative branch of our great Federal system.

It is true that the tax convention with the United Kingdom provides large British concessions for U.S.-owned firms who are heavily taxed in Britain. Obviously, article 9(4) banning the unitary method of taxation is a quid pro quo for the British

concessions. It has been contended that the British may not be as generous if article 9(4) is deleted. Nonetheless, I believe they will make some concession to end what is universally recognized as a discriminatory tax treatment of American companies in the United Kingdom.

Article 9(4), in my considered opinion, invokes an unwarranted intrusion on Federal and State taxing authority. The Constitution vests the power to tax in the two Houses of Congress. Also, the power of States to levy taxes is uncontestable. Only recently, the U.S. Supreme Court upheld the Iowa corporate tax apportionment formula on the ground that the Federal Constitution requires such formula be reasonable in approximating income derived from the State and does not invalidate any formula which taxes income from outside the State.

Now that the State authority has been confirmed by judicial opinion, this treaty seeks to curb that power by treaty negotiation — not by constitutional amendment and not by an act of Congress.

I cannot support such unwarranted extension of the Executive's power, and must vote for the Church reservation on article 9(4).

The PRESIDING OFFICER. Under the previous order, the hour of 11:27 having arrived, the Senate will now proceed to vote on the reservation (No. Ex-1) by the Senator from Idaho (Mr. CHURCH).

Mr. JAVITS. Mr. President, will the Senate grant unanimous consent for Alison Rosenberg of Senator PERCY'S staff to have the privilege of the floor?

The PRESIDING OFFICER. Without objection, it is so ordered.

The yeas and nays have been ordered, and the clerk will call the roll.

The assistant legislative clerk called the roll.

* * *

[p. 18670] The result was announced—yeas 34, nays 44, as follows:

Rollcall Vote No. 169 Ex.

YEAS — 34

Allen	Hatfield, Paul G.	Melcher
Cannon	Helms	Metzenbaum
Church	Hodges	Muskie
Clark	Humphrey	Packwood
Culver	Kennedy	Proxmire
DeConcini	Lavalt	Riegle
Domenici	Leahy	Sarbanes
Durkin	Magnuson	Schmitt
Garn	McClure	Scott
Gravel	McGovern	Stevens
Hart	McIntyre	Zorinsky
Hatfield, Mark O.		

NAYS — 44

Bartlett	Goldwater	Percy
Bayh	Hansen	Randolph
Biden	Hatch	Ribicoff
Bumpers	Hayakawa	Roth
Byrd, Harry P., Jr.	Heinz	Sasser
Case	Hollings	Schwelker
Chafee	Huddleston	Stafford
Chiles	Jackson	Stevenson
Cranston	Javits	Stone
Curtis	Lugar	Talmadge
Danforth	Moynihan	Thurmond
Dole	Nelson	Tower
Eagleton	Nunn	Weicker
Eastland	Pearson	Williams
Glenn	Peil	

PRESENT AND GIVING LIVE PAIR, AS PREVIOUSLY RECORDED — 4

Robert C. Byrd, for.
Sparkman, against.
Abourezk, for.

Matsunaga, for.

NOT VOTING — 18

Anderson	Ford	Long
Baker	Griffin	Mathias
Bellmon	Haskell	Morgan
Bentsen	Hathaway	Stennis
Brooke	Inouye	Wallop
Burdick	Johnston	Young

So Reservation No. Ex. — 1 was rejected.

Mr. JAVITS. Mr. President, the vote now occurs on the treaty, which requires a two-thirds affirmative vote, does it not?

The PRESIDING OFFICER. The Senator is correct.

Under the previous order, the question is on agreeing to the resolution of ratification of Executives K, Q, and J. 94th Congress, 2d session. The yeas and nays have been ordered. The clerk will call the roll.

The second assistant legislative clerk called the roll.

Mr. ROBERT C. BYRD. May we have order in the Senate?

The PRESIDING OFFICER. There will be order. The clerk will suspend until the well is cleared.

Mr. STEVENS. Mr. President, has there been an answer? I had hoped he might tell us what is going to happen after this vote.

Mr. ROBERT C. BYRD. Mr. President, no debate is allowed on a rollcall vote, but I urge Senators not to leave because we expect further rollcall votes today.

Mr. MUSKIE (after having voted in the negative). On this vote I have voted "nay." Senator BENTSEN and Senator LONG, if present and voting, would vote "aye." I, therefore, withdraw my vote.

Mr. CRANSTON. I announce that the Senator from Minnesota (Mr. ANDERSON), the Senator from North Dakota (Mr. BURDICK), the Senator from Kentucky (Mr. FORD), the Senator from Colorado (Mr. HASKELL), the Senator from Maine

(Mr. HATHAWAY), the Senator from Hawaii (Mr. INOUYE), the Senators from Louisiana (Mr. JOHNSTON and Mr. LONG), the Senator from North Carolina (Mr. MORGAN), and the Senator from Mississippi (Mr. STENNIS) are necessarily absent.

I further announce that the Senator from Texas (Mr. BENTSEN) is absent on official business.

I further announce that, if present and voting, the Senator from North Dakota (Mr. BURDICK) would vote "nay."

I further announce that, if present and voting, the Senator from North Carolina (Mr. MORGAN) would vote "yea."

Mr. STEVENS. I announce that the Senator from Tennessee (Mr. BAKER), the Senator from Oklahoma (Mr. BELLMON), the Senator from Massachusetts (Mr. BROOKE), the Senator from Michigan (Mr. GRIFFIN), the Senator from Maryland (Mr. MATHIAS), the Senator from Wyoming (Mr. WALLOP), and the Senator from North Dakota (Mr. YOUNG), are necessarily absent.

I further announce that, if present and voting, the Senator from Tennessee (Mr. BAKER), and Senator from Michigan (Mr. GRIFFIN) would each vote "yea."

The result was announced — yeas 49, nays 32, as follows:

[Rollcall Vote No. 170 Ex.]

YEAS — 49

Allen	Dole	Jackson
Bartlett	Eagleton	Javits
Bayh	Eastland	Leahy
Biden	Glenn	Lugar
Bumpers	Gravel	Matsunaga
Byrd, Harry P., Jr.	Hansen	McGovern
Case	Hatch	Moynihan
Chafee	Hayakawa	Nelson
Chiles	Heinz	Nunn
Cranston	Helms	Pearson
Curtis	Hollings	Peil
Danforth	Huddleston	Percy

Randolph
Ribicoff
Roth
Schweiker
Sparkman
Stafford
Stevenson
Stone
Talmadge
Thurmond
Tower
Weicker
Williams

NAYS — 32

Abourezk
Byrd, Robert C.
Cannon
Church
Clark
Culver
DeConcini
Domenici
Durkin
Garn
Goldwater
Hart
Hatfield, Mark O.
Hatfield, Paul G.
Hodges
Humphrey
Kennedy
Lavalt
Magnuson
McClure
McIntyre
Melcher
Metzenbaum
Packwood
Proxmire
Riegle
Sarbanes
Sasser
Schmitt
Scott
Stevens
Zorinsky

PRESENT AND GIVING A LIVE PAIR, AS PREVIOUSLY RECORDED — 1

Muskie, against.

NOT VOTING — 18

Anderson
Baker
Bellmon
Bentsen
Brooke
Burdick
Ford
Griffin
Haskell
Hathaway
Inouye
Johnston
Long
Mathias
Morgan
Stennis
Wallop
Young

THE PRESIDING OFFICER (Mr. ZORINSKY). Two-thirds of the Senators present not having concurred, the Senate does not advise and consent to the resolution of ratification.

* * *

[p. 18709] TAX CONVENTION WITH THE UNITED KINGDOM OF GREAT BRITAIN AND NORTHERN IRELAND — EXECUTIVE K, 94TH CONGRESS, 2D SESSION

Mr. ROBERT C. BYRD. Mr. President, I wish that both cloakrooms would indicate to Senators on our respective sides that I am prepared to move to reconsider the vote by which the United Kingdom Treaty was rejected. I being a Senator who am qualified to make that motion; and that if I do that, I also will move to reconsider the vote by which the Church reservation was rejected.

Mr. HANSEN. Mr. President, will the Senator yield?

Mr. ROBERT C. BYRD. I am trying to recall how the vote came out. I was on the prevailing side, so I would qualify. I am prepared to move to reconsider that vote.

I also am eligible to move to reconsider the vote on the Church reservation. The reason is that I am advised — if I may have the attention of the distinguished Senator from Idaho (Mr. CHURCH).

The PRESIDING OFFICER. (Mr. RIEGLE). Will the Senator suspend?

Mr. ROBERT C. BYRD. Yes.

[p. 18710] The PRESIDING OFFICER. The Senate will be in order.

Mr. ROBERT C. BYRD. Mr. President, I am advised that the administration, in view of the fact that the treaty was rejected, is willing to have the treaty with the Church reservation included. I am looking at the distinguished Senator from Idaho, and I hope I have been advised correctly. If that is the case, I will be ready shortly to move to reconsider, but I thought Senators should be put on notice.

Mr. CHURCH. Mr. President, I was just looking for the distinguished chairman of the Committee on Foreign Relations in order to convey to him a conversation I had moments ago with the Secretary of the Treasury, Mr. Blumenthal. Mr. Blumenthal told me that he thought it would be better, all things considered, if the treaty were ratified subject to the reservation.

Since this article was the only objection to the treaty, I hope it would be possible for us to agree to the reservation which strikes

article 9(4) from the treaty, and proceed then to a vote of ratification on the treaty itself. It may be that we could agree to have that vote at a time certain, the first of the week, if there is any problem at this hour on Friday, with absentee Senators. But we would want to lock in the reservation at this time; and if we proceed with that understanding, I will be amenable to it.

Mr. JAVITS. Mr. President, will be Senator yield?

Mr. ROBERT C. BYRD. I yield.

Mr. JAVITS. Mr. President, I initiated this matter with the Secretary of the Treasury because I thought he should have the decision as to whether he wanted the treaty instead of an international incident, if we rejected a United States-United Kingdom Treaty on Friday afternoon. He apparently has opted — and he told me the same thing — to have the treaty with the reservation.

I make the following suggestion: It seems to me, in the interest of comity with the United Kingdom, that if we are going to do this, we should do it all. I am advised by Senator STEVENS and Senator PACKWOOD, who also initiated this matter with me, that they are agreeable.

I believe that if the news goes out, it should go out that the treaty has been approved with a reservation, rather than leaving it hanging.

Maybe we still have enough Members here to do it on a rollcall vote, but I am informed by the Parliamentarian that a rollcall vote is not necessary. Therefore, I suggest respectfully to the majority leader and to the acting minority leader, Senator STEVENS, that we have a quorum call because Members will now have been informed that at the end of that quorum we will endeavor to consummate the whole matter unless someone wants to have a rollcall vote.

Mr. ROBERT C. BYRD. Mr. President, I must say I am very reluctant to have a voice vote on a treaty, that requires two-thirds affirmative vote under the Constitution, a treaty which has been rejected today by the Senate on a roll-call vote. I am very

reluctant now to turn around and approve that treaty on a voice vote.

I am going to vote for the treaty if the Church reservation is included, and I am willing to make the motion to reconsider. But I very much hesitate to vote a treaty here that has been a controversial treaty and to vote on it on a voice vote.

I respect the Senator from New York on his reasoning in the matter.

Mr. JAVITS. Mr. President, will the Senator yield?

Mr. ROBERT C. BYRD. I yield.

Mr. JAVITS. In the first place, I said if anyone wants a rollcall, of course. Second, may I make this inquiry? Have Members been advised that the last vote was the last one so they have a right to scatter?

Mr. STEVENS. Yes.

Mr. ROBERT C. BYRD. They have not advised to that effect on this side of the aisle.

Mr. STEVENS. Mr. President, if the Senator will yield, they have not been advised that it was for sure, but they have been advised on this side of the aisle that so far as we could determine that was the last business that would come before the Senate which would require rollcall today and we would do our best to have any rollcalls which might come up carried over until Monday. We made no assurances. I can give the majority leader that assurance. But as now when we originally started talking about this particular issue, it was on the basis that we will do everything we could here today short of a rollcall and have the rollcall on Monday, and that was conveyed to Senators who inquired on this. The word started passing that we might reconsider the treaty. I indicated it was my understanding after talking to the distinguished Senator from Idaho that we would be willing to have the rollcall vote take place on Monday. But we have not assured anyone, I say to my good friend from West Virginia. I think there has sort of been a gentlemen's interpretation here that is highly

unlikely that there would be a controversial vote take place here this afternoon.

Mr. ROBERT C. BYRD. Mr. President, in the future, may I say, in all good spirit to my friend — and he is my friend — from Alaska, that I hope — it is not my attempt to presume to control the minority side or what is being said over there — but I hope that in the future before word is given to Senators that there is not likely to be any rollcall votes on a given date that at least I be given the courtesy of an inquiry because I may know something or may have some information that would be helpful to the minority in making that judgment and we may get into a situation on a day when I would have to proceed in any event and I do not want to do anything that would embarrass the minority or embarrass any Member of the minority or the majority. But I hope that in the future — and I say this most respectfully — at least the majority leader of the Senate would at least be contacted to ask if in his judgment there is likely to be any other rollcall votes today.

Mr. STEVENS. I accept the guidance.

Mr. ROBERT C. BYRD. If I say in my judgment there will not be, then I will take the responsibility for whatever happens.

Mr. STEVENS. I accept the guidance from my distinguished friend and I will in the future tell them that my crystal ball is more cloudy than I thought it was today. I just read the crystal ball. Again we gave no assurances, but I read the circumstances as I saw them, I say to my friend, and I thought that that was proper. I accept the guidance and apologize to the majority leader if I have indicated we have gone further than we should in that regard. I really believe, though, as the Senator from New York, that we should not after having voted on this now have a rollcall vote which would not give an opportunity to those Senators who left, and we knew some left right after the vote, and not give them an opportunity now to vote for the treaty with article 9(4) deleted because many Senators took the position that they would vote for the treaty but for article 9(4) and they stood with the Senator from Idaho, as I did, and I think they now should have the opportunity to vote for the treaty with the reservation as they originally intended to do.

Mr. CHURCH. Mr. President, will the Senator yield?

Mr. SPARKMAN. Mr. President, will the majority leader yield to me briefly?

Mr. ROBERT C. BYRD. I yield.

Mr. SPARKMAN. I wish to say to the majority leader that I am perfectly willing to go along with that kind of an arrangement. I think it is very good. Let me add just a personal note. This is twice I have been caught in a jam on this very thing. In the committee I voted to report the reservation to the Senate because I felt it was something that the Senate should debate and should know about even though I was not in favor of it finally, and I find myself again in a position of endorsing something that I am not too strongly for. Nevertheless, we are seeking not only to get a peaceful settlement between the two nations, but we want to keep peace here in the Senate. I will be very glad to accede to the arrangement.

Mr. ROBERT C. BYRD. I thank the distinguished Senator from Alabama, the chairman of the committee.

Mr. President, I ask unanimous consent that the colloquy thus far be as in executive session.

The PRESIDING OFFICER. Without objection, it is so ordered.

Mr. JAVITS. Mr. President, will the Senator yield?

Mr. ROBERT C. BYRD. I yield.

Mr. JAVITS. Of course, I did not suggest a voice vote until we had a quorum and no one wanted a rollcall.

Mr. ROBERT C. BYRD. Sure.

Mr. JAVITS. If anyone wanted a rollcall, I thoroughly agree with Senator STEVENS and Senator SPARKMAN.

Mr. SPARKMAN. I wanted to say this: I have always felt that a treaty should receive a rollcall vote.

Mr. ROBERT C. BYRD. I have that feeling also.

I hesitate for the press stories to go out that only three Senators were on the floor.

[p. 18711] Mr. JAVITS. Absolutely.

Mr. ROBERT C. BYRD. That is not the case now. But that approval of the resolution of ratification of the treaty was adopted by two-thirds vote of the Senate when seven Senators were on the floor.

So I agree with the chairman. There should be a rollcall vote.

Mr. CHURCH. Mr. President, will the Senator yield for 1 minute?

Mr. ROBERT C. BYRD. I yield.

Mr. CHURCH. At the same time, it seems to me that the distinguished Senator from New York has made a very good point, that in the national interests it would be better for us to wrap this up at once so that the wrong message does not go out.

Mr. JAVITS. The Senator is exactly right.

Mr. CHURCH. And that misgivings are not created pending a final vote in the Senate next week. So I hope there is a way that we might do it today.

Mr. ROBERT C. BYRD. Very well.

Mr. MAGNUSON addressed the Chair.

Mr. ROBERT C. BYRD. Mr. President. I say to the distinguished Senator from Idaho, the distinguished Senator from New York, and the distinguished Senator from Alabama I shall ask unanimous consent in a moment to proceed in a way that will put the vote on the treaty over until Monday at a given time, and it will be late in the day. But my question is: Do you want the reservation to be adopted today by unanimous consent?

Mr. JAVITS. That I could not agree to because I wish to put both over and I wish to confine the whole proceedings to the reservation and the vote on the treaty so we have nothing else.

Mr. ROBERT C. BYRD. And back to back.

Mr. JAVITS. Right.

Mr. CHURCH. Mr. President, will the Senator yield?

Mr. ROBERT C. BYRD. I yield to the Senator from Idaho.

Mr. CHURCH. Mr. President, as to the understanding that I reached, my understanding, and I believe it was the understanding of the Senator from Alaska, was that we would settle the matter of the reservation that everyone was agreeable to accepting, so I do not see why that must be made the subject of a Senate vote. That is a basis on which we are trying to reach an agreement.

Mr. JAVITS. May I tell the Senator why?

Mr. CHURCH. I cannot agree to that. Going over until next Monday and then having a vote on it is quite a different thing than having an understanding that we are going to do it.

Mr. JAVITS. If I may just tell the Senator why, the treaty may be turned down again. Why should we have it turned down again if the reservation is in? In other words, if I may just finish, our understanding is that there will be the reservation and the treaty and that the treaty will be approved. They should be done together because other Members may get other ideas on this, that, or something else.

Mr. ROBERT C. BYRD. Mr. President, may I offer this suggestion, and I think it will get us out of this wrangle.

I would ask unanimous consent that the vote on the — Mr. President, may we have order? It is a little difficult for a Senator who has a one-track mind and who tries to concentrate on that one track to carry on a conversation with the Chair and a number of Senators in a serious way when there are so many conversations going on around the Chamber. I wonder if I might proceed in an orderly fashion with the Chair's protection.

I thank the Chair.

UNANIMOUS-CONSENT REQUEST

Mr. President, I ask unanimous consent, as in executive session, that on Monday at the hour of 6 p.m.-5:30 p.m. — I have a number of Senators who want votes late — all right, let us make it

Tuesday then — that on Tuesday at the hour of 10 a.m. a vote occur on the Church reservation to the treaty; that if the vote on the Church reservation is in the affirmative, then the Senate proceed to vote immediately on the resolution of ratification of the treaty and protocols en bloc.

In the alternative, if the vote on the Church reservation is in the negative, that no vote occur, no further vote occur, on the treaty, and that the vote stand as was given today. That protects the Senator from Idaho and it protects the Senator from New York.

Mr. JAVITS. It sounds all right to me, but no other amendment—

Mr. SPARKMAN. Mr. President, I want to ask a question there. Why separate the reservation and the treaty rather than having it as one vote, because any part of it, if it is to be turned down, I think it is a defect in the ratification of the treaty.

Mr. ROBERT C. BYRD. Well, the chairman has proposed another approach. I ask unanimous consent that at 10 o'clock on next Tuesday morning a vote occur on the Church reservation and the treaty with protocols en bloc. In that way if the Church reservation falls everything falls. If the Church reservation carries, if that vote carries, it carries everything with it.

Mr. STEVENS. Mr. President, will the Senator yield for just one moment? There is one difficulty and that is the treaty and protocols would have to carry by two-thirds whereas we only need a majority vote to carry the Church reservation, and I hope we understand what we are doing. I am not going to object. I just want to make sure everybody understands.

Mr. JAVITS. Mr. President, will the Senator yield to me?

Mr. STEVENS. Yes.

Mr. JAVITS. As a practical matter that is exactly what happened now. You really need the two-thirds either way no matter how you look at it. The treaty can always be turned down if a number of us should turn against it. We can turn it down. So I think the suggestion of the chairman protects everyone.

Mr. STEVENS. I just want the Senator from New York to understand he has to vote for the Church reservation in order to vote for the treaty.

Mr. JAVITS. I will vote for the whole treaty as well as the reservation.

Mr. ROBERT C. BYRD. Mr. President, the Senator from Alaska is preeminently correct, but the Senator from New York also has preeminently analyzed the practical situation. If we pass the treaty you have to have two-thirds. So, if you get a two-thirds vote, then the Church reservation which only required a majority vote got a two-thirds vote. But the treaty which has to have two-thirds vote has it also.

Mr. CHURCH. In other words, on Tuesday at the designated time the Senate will, in effect, vote again on the resolution of ratification of the treaty subject to the Church reservation.

Mr. STEVENS. Vote en bloc. Both items will be before the Senate at the same time.

Mr. CHURCH. Both items will be before the Senate at the same time and will stand or fall together.

Mr. ROBERT C. BYRD. May I say, Mr. President, if the Senator will allow me, that I much prefer the earlier request to this one. I much prefer to vote on the Church reservation which requires only a majority vote, and then on the basis of the outcome, vote on the treaty back-to-back. I much prefer that.

Mr. CHURCH. I prefer that.

Mr. ROBERT C. BYRD. That does not require that a reservation have a two-thirds vote, and it is just as simple as that. All the difference is that we will be having two rollcall votes back-to-back.

Mr. CHURCH. I much prefer the formulation of the majority leader, too.

Mr. SPARKMAN. May I say to the leader, Mr. President, that I have that point in mind and I was going to ask if the reservation would only require a majority vote whereas the treaty

requires a two-thirds vote, that therefore the vote probably should be separate. I will cut out the "probably."

Mr. ROBERT C. BYRD. It was on the chairman's recommendation that we are about to tie them together. I am glad he has changed his viewpoint.

Mr. SPARKMAN. I do not mean to necessarily tie the votes together but the time they would come up.

Mr. JAVITS. Mr. President, will the Senator yield to me?

Mr. ROBERT C. BYRD. Yes.

Mr. JAVITS. We are all on the same wicket and we are only trying to do what is best. Let us remember that the Church amendment was defeated by a majority and, hence, you are asking Members to change their votes on the Church reservation; whereas if you adopt the chairman's suggestion and the slight risk which is involved — it is not great because you can always turn down the treaty as you gentlemen have shown — if you adopt the chairman's suggestion you do not require Members to stultify themselves.

I will vote for the treaty with the Church reservation incorporated in it. I cannot vote for the Church reservation. I am not a fool; I opposed it. I think it is wrong. But on balance if I have got a treaty and that is the price of it I am going to pay it. So I really hope that is the route we will go. You also protect yourselves. You have got plenty of votes to turn it down. Then it [p. 18712] is a tabula rasa. That is where we are right now.

Mr. CHURCH. I would like, if I might, Mr. President, to put a question to the distinguished majority leader. Is it possible by unanimous consent simply to agree to vote on Tuesday on the ratification of the treaty subject to the Church reservation?

Mr. ROBERT C. BYRD. Yes.

Mr. MATSUNAGA. As amended.

Mr. CHURCH. So the Senate is faced with the treaty subject to the reservation, and then it either votes for it or votes against it,

even though the Senate has not independently acted by a majority vote to adopt the Church reservation.

Mr. ROBERT C. BYRD. Yes.

Mr. CHURCH. Very well. I think that is the best way to proceed. Let us understand the treaty is subject to the reservation, this by unanimous consent, and to proceed to a vote on the treaty in that form on Tuesday.

Mr. ROBERT C. BYRD. We only have one vote.

Mr. JAVITS. One vote, and no other amendments or debate will be in order; is that correct, Mr. Leader?

Mr. ROBERT C. BYRD. Right.

Mr. SPARKMAN. I would like to ask a parlimentary question, Mr. President.

Mr. ROBERT C. BYRD. I yield for that purpose.

Mr. SPARKMAN. Can the reservation be adopted by majority vote separate and apart from the treaty itself?

Mr. ROBERT C. BYRD. The answer is yes.

Mr. STEVENS. May I say to the chairman that the effect of the suggestion of the Senator from Idaho is that the unanimous-consent request is going to adopt it right now.

Mr. CHURCH. That is right.

Mr. STEVENS. That is my understanding. What we are doing is we are saying in the unanimous-consent request that the treaty is going to be before us subject to the Church reservation which deletes article 9(4) so the only vote we will have is on the treaty without article 9(4).

Mr. CHURCH. That is right.

Mr. SPARKMAN. Mr. Leader, we will have a rollcall vote?

Mr. ROBERT C. BYRD. Yes.

Mr. SPARKMAN. I think all treaties should have a rollcall vote.

* * *

UNANIMOUS-CONSENT AGREEMENT

Mr. ROBERT C. BYRD. Mr. President, I ask unanimous consent that the vote by which the Resolution of Ratification to the treaty was rejected be reconsidered, and that the vote for such reconsideration be considered as being in the affirmative; that the vote, then, on the reservation by Mr. CHURCH, by which the reservation was rejected, be reconsidered; and that a vote occur on Tuesday morning next, at the hour of 10 o'clock a.m., without further debate, motion, reservation, amendment, et cetera, on the United Kingdom Treaty with the proviso that the Church reservation is considered included therein.

The PRESIDING OFFICER. Is there objection?

Mr. CRANSTON. Mr. President, reserving the right to object, my colleague, Senator HAYAKAWA, and I have been conferring on this matter. Our State is one of those with a particular interest in the matter.

We would prefer that there be a separate vote on the Church reservation.

Mr. CHURCH. No, we cannot do that.

Mr. CRANSTON. Let me finish my remarks. We would prefer that there be a separate vote on the Church reservation, because we would like to register our opposition to the Church reservation. However, we realize that if we prevailed, that would sink the treaty.

We think, all in all, although it does not have much impact on California with the Church reservation attached to it, it is better to permit the United Kingdom Treaty to go through. Therefore, we will not object, much as we are tempted to do so.

The PRESIDING OFFICER. Without objection, it is so ordered.

● Mr. PACKWOOD. Mr. President, I voted today in favor of the Church reservation of the United States-United Kingdom Tax Treaty. This reservation would have preserved Oregon's right to apply the unitary method of accounting in determining the tax

liability of British corporations doing business in Oregon. Unfortunately, the Senate defeated this reservation by a vote of 34-44.

Since the Senate failed to approve the Church reservation, I voted against the treaty. So did 32 other Senators. As a result, the Senate failed to ratify the treaty by a vote of 49-32.

This result ~~was~~ ~~be~~tter than ratifying the treaty without the reservation.

However, several of us who participated in the debate believe that if the Senate reconsiders the vote by which the Church reservation was defeated, and if that reservation is approved, the vote by which the treaty was rejected should be reconsidered.

I believe such a vote would be favorable to treaty objectives. This would protect Oregon's and other States' right to apply the unitary method of accounting to British corporations. It would also give the British Government the opportunity to accept or reject the treaty with the Church reservation, with the hope of saving the other treaty provisions.

Apparently this is acceptable to the parties involved. As a result, the Senate will reconsider the treaty next Tuesday at 10 a.m. By unanimous consent, the form of the treaty under consideration at that time will include the Church reservation.

I appreciate the cooperation of Senators JAVITS, STEVENS, CHURCH, SPARKMAN and BYRD, and the Department of the Treasury in helping to bring about this more constructive result.●

Mr. MAGNUSON. Mr. President —

Mr. ROBERT C. BYRD. Mr. President, I still have the floor, if the Senator from Washington will allow me a moment. I am going to call up his matter in just a minute.

* * *

[p. 19076] EXECUTIVE SESSION

TAX CONVENTION WITH THE UNITED KINGDOM OF GREAT BRITAIN AND NORTHERN IRELAND — EXECUTIVE K, 94TH CONGRESS, 2D SESSION

The PRESIDING OFFICER. Under the previous order, the Senate will now go into executive session to vote, upon reconsideration, on the resolution of ratification of Executive K. 94th Congress, 2d session, as amended by the Church reservation.

The treaty will be stated by title.

The second assistant legislative clerk read as follows:

Executive K. 94th Congress, 2d Session, Tax Convention with the United Kingdom of Great Britain and Northern Ireland, with two protocols.

The PRESIDING OFFICER. The yeas and nays have been ordered, and the clerk will call the roll.

The legislative clerk called the roll.

Mr. CRANSTON. I announce that the Senator from South Dakota (Mr. ABOUREZK), the Senator from Minnesota (Mr. ANDERSON), the Senator from Indiana (Mr. BAYH), the Senator from Mississippi (Mr. EASTLAND), the Senator from Alaska (Mr. GRAVEL), the Senator from Hawaii (Mr. INOUYE), the Senator from Louisiana (Mr. LONG), and the Senator from Mississippi (Mr. STENNIS) are necessarily absent.

I further announce that the Senator from South Dakota (Mr. MCGOVERN) is absent on official business.

I further announce that, if present and voting, the Senator from Minnesota (Mr. ANDERSON) and the Senator from Louisiana (Mr. LONG) would each vote "yea."

Mr. STEVENS. I announce that the Senator from Massachusetts (Mr. BROOKE), the Senator from Maryland (Mr. MATHIAS), and the Senator from Illinois (Mr. PERCY) are necessarily absent.

I also announce that the Senator from California (Mr. HAYAKAWA) is absent to attend the funeral of a Member of the House of Representatives.

I further announce that, if present and voting, the Senator from Illinois (Mr. PERCY) would vote "yea."

The yeas and nays resulted — yeas 82, nays 5, as follows:

[Rollcall Vote No. 178 Ex.]

YEAS — 82

Allen	Hansen	Nelson
Baker	Hart	Nunn
Bartlett	Haskell	Packwood
Bellmon	Hatch	Pearson
Bentsen	Hatfield, Mark O.	Pell
Biden	Hatfield, Paul G.	Proxmire
Bumpers	Hathaway	Randolph
Burdick	Heins	Ribicoff
Byrd, Harry F., Jr.	Helms	Riegle
Byrd, Robert C.	Hodges	Roth
Cannon	Hollings	Sarbanes
Case	Huddleston	Sasser
Chafee	Humphrey	Schmitt
Chiles	Jackson	Schweiker
Church	Javits	Sparkman
Clark	Johnston	Stafford
Cranston	Kennedy	Stevens
Culver	Lavait	Stevenson
Danforth	Leahy	Stone
DeConcini	Lugar	Talmadge
Dole	Magnuson	Thurmond
Domenici	Matsunaga	Tower
Durkin	McIntyre	Wallop
Eagleton	Meicher	Weicker
Ford	Metzenbaum	Williams
Garn	Moynihan	Young
Glenn	Muskie	Zorinsky
Griffin		

NAYS — 5

Curtis	McClure	Scott
Goldwater	Morgan	

NOT VOTING — 13

Abourezk	Gravel	Mathias
Anderson	Hayakawa	McGovern
Bayh	Inouye	Percy
Brooke	Long	Stennis
Eastland		

The PRESIDING OFFICER. On this vote the yeas are 82, the nays are 5. Two-thirds of the Senators present and voting having voted in the affirmative, the resolution of ratification and the Church reservation thereto, upon reconsideration, are agreed to.

Mr. ROBERT C. BYRD. Madam President, I move to reconsider the vote by which the resolution of ratification and the Church reservation thereto were agreed to.

Mr. SPARKMAN. I move to lay that motion on the table.

The motion to lay on the table was agreed to.

[p. 19077] Mr. ROBERT C. BYRD. Madam President, I ask unanimous consent that Mr. JAVITS may have 5 minutes, before going back to legislative session, to address some comments to the treaty.

Is there anyone else who wishes to speak with reference to the treaty?

The PRESIDING OFFICER. Without objection, it is so ordered.

The Senator from New York.

Mr. JAVITS. Madam President, I hope the Senate realizes that what we have done is very serious. We have for all practical purposes eliminated a very important provision of this treaty for which the United Kingdom believed it had entered into the treaty. For all intents and purposes it was for the British the critical balance contained in the treaty.

The United Kingdom considers the unitary tax system—Madam President, may we have order?

The PRESIDING OFFICER. The Senate will be in order.

Mr. JAVITS. Madam President, the United Kingdom considered article 9(4) the quid pro quo for a very large retroactive refund of about $375 million and an annual prospective refund of about $85 million to American investors. These sums, which would return to the United States are very meaningful to the U.S. Treasury. I regret, Madam President, that the British considered that the quid pro quo for providing relief to U.S. investors was this provision which would have limited application of the system of unitary taxation by a few States which the British regarded as very onerous and invidious to them.

The Senate decided that that reservation was inappropriate and defeated it. But the opponents, those who proposed the reservation, succeeded—

The PRESIDING OFFICER. Will the Senate please be in order.

Mr. JAVITS. I thank the Chair.

Those who proposed the reservation succeeded in getting enough votes, since they only needed one-third of the votes to defeat the treaty, notwithstanding that the treaty itself had a very heavy majority of the Senators voting.

Now, you really have to understand the processes of the Senate and the Constitution—and I may say that the British do—to come to understand that result. So, notwithstanding the fact that a decisive majority of the Senate is for this treaty in all its elements, it was nonetheless defeated.

It is my information that this treaty will be resubmitted to the British Parliament. What the British Parliament will do with it I do not know. But I rise this morning because our voices will be heard in the United Kingdom, and my own opinion is, and the opinion of the great majority of the Senate was, that it is an entirely fair deal that the few States which were using the unitary taxation system would be losing very little, and that the overall

national interest of the United States dictated ratification. That is the way the majority of the Senate felt and, indeed, the State of California, the largest State that would be a beneficiary of continued global application the unitary tax system, through its two Senators who voted for ratification, and its Governor who advised us that he thought on balance it was in the high economic interest of his State, supported ratification of the treaty without a reservation.

Therefore, I hope, Madam President, that the Members of Parliament will see the situation as we see it, and that they will accept the treaty, on the ground that a majority, a heavy majority, of the Senate feels as they do. I also hope that the British will negotiate another treaty or a protocol with the United States to deal with such elements of their tax situation as they consider to be fair.

Obviously, a new protocol cannot be as complete as was contained in this treaty. Nonetheless, I hope very much that just like we kept the matter open, and as I, the strongest advocate of the treaty in the Senate voted for its ratification even though this provision of the treaty removed by the reservation, that the British will ratify the treaty too. I hope that we will be able to deal with the tax situation by agreement, and that this reservation will be considered one of those incidents of our constitutional system which must be accepted, just like we accept such incidents in the British constitutional system. It is my deepest hope that the overall friendship and longstanding relationship between ourselves and the United Kingdom will dictate that this treaty should be accepted on both sides, notwithstanding my disappointment and that of the British Government with this result in the Senate.

I yield to my colleague from California.

Mr. CRANSTON. I thank the Senator for yielding. I would like to associate myself with the viewpoint expressed by the distinguished Senator from New York.

We certainly can and must explore what can now be done in the Senate by the normal process of dealing with tax laws, with a majority in favor of a change in this matter to accomplish what is

needed to meet our goals and to meet the goals of the people of England.

I would also just like to add that we have been exploring, since the original defeat late last week, with officials in California, the possibility of taking action in California in the State legislature to remedy the problem, and there is a strong possibility that that can be accomplished, and I urge the British to take that into account, too.

Mr. JAVITS. I thank my colleague. He adds a very strong dimension to what I have said. We will try in our own Federal tax law and in that of States like California to deal with this problem in a way which will at least try to cover some of the concerns raised in the deliberation on this treaty.

I thank my colleague. I yield to the Senator from Ohio.

Mr. GLENN. Madam President, I thank the Senator from New York.

I, too, would like to associate myself with his remarks. We went into this issue in considerable depth in the Committee on Foreign Relations, and I, too, hope the British Parliament sees fit to go ahead and approve this treaty with the idea that we continue negotiating on this rather vexing problem.

I have felt very strongly that the unitary tax injects States really into an international commerce situation which was never intended. But, as I understand it, this has been tested in the courts and found to be constitutional. I would hope the British would take the view that some of us here are taking and that is that the treaty is worth approving as is, and will continue negotiating on this other problem which I feel, and I am sure the Senator from New York feels, from our previous conversation, is particularly unfair.

I thank the Senator.

Mr. JAVITS. I thank my colleague very much. He was very helpful.

I yield to my colleague who managed the bill, the Senator from Rhode Island (Mr. PELL).

The PRESIDING OFFICER. The Senator's 5 minutes have expired.

Mr. JAVITS. Madam President, I ask unanimous consent for 2 additional minutes.

The PRESIDING OFFICER. Without objection, it is so ordered.

Mr. PELL. Madam President, I would like to second the views advanced by the Senator from New York. This was a good treaty. It was approved by the majority of the Senate. It is still a better treaty than none the way we passed it, and I would hope the British Parliament would see fit to ratify it.

I recognize that what we have done with our reservation is to remove some of the attractiveness of this treaty from the United Kingdom's viewpoint. So our negotiators, when they get back together, are going to have to figure out a little bit whether the pot will have to be sweetened and what will be necessary to sweeten the pot.

But I would think this treaty should move along, and I would hope that the Members of Parliament, when they do consider it, will bear in mind the remarks on the Senate floor, and will bear in mind the fact that the majority of our colleagues supported it, will bear in mind that it is to the mutual advantage of both our nations to move down this road and ratify the treaty along these lines.

Mr. SPARKMAN. Madam President, I am glad we have had this very successful vote in behalf of this treaty. While I opposed the Church reservation, I did state at the time that we could live under it, and that the treaty was of such importance, this treaty between the two countries, that by all means I felt that we should accept the reservation and [p. 19078] ratify this treaty. I am gratified that the vote was so successful.

Mr. JAVITS. Madam President, I ask unanimous consent that a statement by Senator PERCY be placed in the RECORD in connection with the treaty.

The PRESIDING OFFICER. Without objection, it is so ordered.

STATEMENT BY SENATOR PERCY

I deeply regret the action taken last week by the Senate on the United States-United Kingdom Tax Treaty. Although the reservation which effectively cancels article 9(4) of the treaty was defeated, there were not the required votes of ⅔ of the Senators present and voting to approve ratification of the treaty.

As I stated during last week's debate, I believed that the treaty was beneficial to the United States, that it encouraged the free flow of trade and investment, and that it was an important contribution to our Government's policy of promoting international economic cooperation.

I felt it was more than adequately demonstrated during the debate that article 9(4) of the treaty did not represent a blanket prohibition on a State's use of the unitary apportionment method of taxation, but only restricted its use when applied to the operations of a United Kingdom corporation not doing business in a State. It seemed to me this use of the unitary method was unreasonable and unfair. Furthermore, it has been a disincentive for investment in the United States, as the Senators and Governor from California can attest. Finally, I believe it was clearly shown that article 9(4) would not in any way have created a tax preference for foreign ownership of U.S. farmland.

However, the Senate has worked its will, and it is now incumbent upon us to approve the treaty as amended by the reservation to article 9(4), in the hope that at least some of the treaty can be salvaged. We cannot predict what conditions the United Kingdom will now seek to compensate for the loss of the benefits under article 9(4). But at least we will not be giving what could have been interpreted by our friends and allies in the United Kingdom as a slap in the face if we had just let the treaty die. At least this will provide an opportunity for further discussions by both governments. This is my view and I know it is shared by many interested parties in Illinois. Therefore, I urge support for the amended treaty.

Mr. MORGAN. Mr. President, this morning, I voted against the proposed United States-United Kingdom Tax Treaty which included the Church reservation. My reasons for doing so were a

concern over method, the lack of equitability, the potential for increased costs to the American taxpayer, a further delay in obtaining tax advantages, and the possibly negative impact on current tax negotiations with France, Germany, and Canada.

Last Friday, we rejected the Church reservation by a comfortable majority only to find it reappear in today's version of the vote. Thus we combined two issues, one which requires only a majority vote, namely the Church reservation, and ratification of the treaty and its two protocols which require a two-thirds vote. I would have very much preferred to follow the original suggestion of the Senator from West Virginia, made last Friday, to have two votes back to back, thereby keeping votes and issues apart. I am convinced that in this case we would have had a treaty today including article 9(4).

As you will recall, Mr. President, article 9(4) places some restrictions on the application of the unitary tax method to British corporations operating in this country. It would have constituted only a minor concession as attested to by the Governor of my State, and the Governors of many other States. In return, the British Government would have been prepared to grant the United States a tax refund of approximately $375 million and a future annual tax saving of $85 million.

It was a concession for a concession. With the deletion of article 9(4), we are jeopardizing this additional income to the possible disadvantage of the American taxpayer.

With the Church reservation now included in the treaty, a treaty which had already been passed by the British Parliament, the document will now have to be renegotiated. This will not only mean a costly delay, but in the process, we may very well lose some of the tax benefits that had been stipulated earlier. There is also every reason to believe that our tax treaties with other West European countries and Canada may be affected if we are not willing to offer a quid pro quid.

By voting for the Church reservation together with the treaty, my colleagues have placed themselves at the mercy of the British Parliament not to reconsider their own tax concessions to us. We are thus relying on their good will which we were not willing to

show ourselves. This issue is far from closed and I have no doubt that this body will again be asked to deliberate a new tax treaty with the United Kingdom, one which will unfortunately be less favorable than the version which was before us earlier.●

* * *

(23)

No. 92-1384

In the Supreme Court

OF THE

United States

OCTOBER TERM, 1993

BARCLAYS BANK PLC,
Petitioner,

vs.

FRANCHISE TAX BOARD,
AN AGENCY OF THE STATE OF CALIFORNIA,
Respondent.

On Writ of Certiorari to the Court of Appeal of the State of California in and for the Third Appellate District

JOINT APPENDIX — VOLUME II

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Certiorari Granted November 1, 1993

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The following opinions and orders have been omitted in printing this joint appendix because they appear on the following pages in the Appendix to the printed Petition For A Writ Of Certiorari:

EXHIBIT 37B

96TH CONGRESS SENATE EXECUTIVE REPT.
1st Session No. 96-5

THIRD PROTOCOL TO THE 1975 INCOME TAX CONVENTION WITH THE UNITED KINGDOM OF GREAT BRITAIN AND NORTHERN IRELAND, AS AMENDED

REPORT

OF THE

COMMITTEE ON FOREIGN RELATIONS
UNITED STATES SENATE

ON

EXECUTIVE Q, 96TH CONG., 1ST SESS.

THIRD PROTOCOL TO THE
1975 INCOME TAX CONVENTION
WITH THE UNITED KINGDOM OF
GREAT BRITAIN AND
NORTHERN IRELAND, AS AMENDED

June 15, 1989, — Ordered to be printed
(Under authority of the order of the Senate of June 14, 1979.)

U.S. GOVERNMENT PRINTING OFFICE
WASHINGTON: 1979

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96TH CONGRESS 1st Session | SENATE | EXECUTIVE REPT. No. 96–5

[p. 1] THIRD PROTOCOL TO THE 1975 INCOME TAX CONVENTION WITH THE UNITED KINGDOM OF GREAT BRITAIN AND NORTHERN IRELAND, AS AMENDED

JUNE 15, 1979.—Ordered to be printed
(Under authority of the order of the Senate of June 14, 1979.)

MR. CHURCH, from the Committee on Foreign Relations, submitted the following

REPORT

[To accompany Ex. Q, 96th Cong., 1st sess.]

The Committee on Foreign Relations, to which was referred the Third Protocol to the 1975 Tax Treaty with the United Kingdom of Great Britain and Northern Ireland for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income and capital gains (Executive Q) (referred to as the proposed protocol), having considered the same, reports favorably thereon without reservation and recommends that the Senate give its advice and consent to ratification thereof.

I. PURPOSE

The proposed third protocol to the proposed income tax treaty between the United States and the United Kingdom deals with issues which arose during the previous consideration of the treaty by the United States Senate and with other matters raised during discussion of those issues between the United States and the United Kingdom.

* * *

[p. 5] VII. EXPLANATION OF PROTOCOL PROVISIONS

A comprehensive article-by-article explanation of the proposed protocol to the proposed income tax treaty between the United States and the United Kingdom is set forth below.

Article I. Use of worldwide combination/unitary method of apportionment

In conformity with the Church reservation, the proposed protocol makes Article 9(4) of the proposed treaty, which restricts the use of the worldwide combination/unitary method of apportioning income, inapplicable to state or local governments. The provisions of Article 9(4) would continue to apply, however, to the United States and United Kingdom governments.

Under the protocol, political subdivisions and local authorities of either country are free to use formula methods to apportion income, deductions and other items among related enterprises in determining income subject to their taxes, so long as such methods do not violate the proposed treaty's nondiscrimination provisions *(Article 24)*.

Article 9(4) of the proposed treaty would have limited the methods by which the United States, the United Kingdom, and political subdivisions and local authorities of each country could tax enterprises of the other country (or enterprises which are directly or indirectly controlled by enterprises of the other country). (This provision is not found in other U.S. tax treaties.) The proposed treaty would have provided that, in determining the tax liability of such an enterprise doing business within their respective jurisdictions, the United States, the United Kingdom and their political subdivisions and local authorities could not take into account the income, deductions, receipts or outgoings of a related enterprise of the other country, or of any third country. This provision of the proposed treaty was intended to apply to those states of the United States (principally California, Oregon, and Alaska) which, in determining the amount of income of a business operating within the state which is to be apportioned to that state for income tax purposes, require combined reporting of

all related business operations (including related business operations of affiliated U.S. and foreign corporations, whether or not doing business within the state). The national governments of the United Kingdom and the United States do not apportion income between jurisdictions under this method but rather allocate income between related enterprises under arm's-length principles. In addition, the political subdivisions and local authorities of the United Kingdom do not impose income taxes.

The proposed protocol modifies this provision by eliminating its applicability to political subdivisions and local authorities of the United States and the United Kingdom. This is in conformity with the reservation proposed by Senator Church and adopted by the [p. 6] Senate as part of its resolution of ratification of the proposed treaty. The provision would, however, continue to apply to the two national governments. (Conforming changes are made in Article 2 of the proposed treaty (*Taxes covered*) to reflect this narrowed scope.)

Moreover, the proposed treaty, like most other U.S. tax treaties, contains a provision (*Article 9(1)*) similar to that contained in the Internal Revenue Code (sec. 482) which recognizes the right of each county to make an allocation of income in the case of transactions between related persons, if an allocation is necessary to reflect the conditions and arrangements which would have been made between unrelated persons. The limitation in Article 9(4) applies only to cases where an allocation is made without regard to any application of the arm's-length standard. Of course, both countries may apply apportionment formulas, including formulas that take into account attributes of related entities, as a method of achieving an arm's-length price for a transaction between related entities. Moreover, apportionment formulas may be used as a method of apportioning income of related entities to the extent that it is established that they are not dealing on an arm's-length basis. The proposed treaty does not affect U.S. tax rules for allocating and apportioning income, deductions, and other items among related enterprises (Code sec. 482), nor is it applicable to the U.S. tax rules concerning the source of income and the deductions attributable thereto (Treas. Reg. § 1.861-8).

During last year's debate both in the Foreign Relations Committee and on the Senate floor, opponents of Article 9(4) argued that any prohibition of the right of states to use worldwide combination under the unitary tax system should be addressed legislatively rather than through the treaty process. Even some supporters of Article 9(4), while not questioning the propriety of the Article, indicated their preference for Congressional consideration through the legislative process of the issue. The Foreign Relations Committee notes that Section 303 of S. 983, the Interstate Taxation bill introduced by Senator Mathias, would accomplish for all nations what Article 9(4) of the U.S.-U.K. Tax Treaty sought to accomplish for the U.K.

The Committee urges the tax-writing Committees of the Congress — the Finance and the Ways and Means Committees — to hold hearings in the very near future on S. 983 in order to permit all sides of the issue to have their views known for the record. In addition, such legislation will give the Congress, which has the responsibility to resolve on the federal level inconsistent state taxation policies, the opportunity to take a position on the merits of the issue.

The Committee also notes both Senator Mathias' statement before the Committee in support of the Treaty and the Third Protocol and his view that the British "Parliament will ratify the U.S.-U.K. Treaty only if they perceive that we are serious about making progress on the Interstate Taxation bill . . ." The Committee wishes to make clear that it considers expeditious treatment of the Treaty by both the U.S. Senate and the U.K. Parliament to be critical in order to permit the benefits of the Treaty to flow to both sides.

* * *

[p. 15] IX. ADDITIONAL VIEWS OF SENATOR HOWARD BAKER

In reporting favorably the Third Protocol further amending the Tax Convention between the United States and the United Kingdom, the committee has recognized the importance of ratification of the Convention by both countries.

It is worth noting that the chances of ratification in timely fashion by the Parliament will be enhanced by evidence of Congressional intent to consider domestic legislation to regulate the authority of the several States and their local jurisdictions to tax foreign multinational corporations under a unitary method of taxation. The committee has information that an Early Day Motion was introduced on June 11, 1979, in the House of Commons by members of the governing Conservative Party. If approved, that Motion would instruct Her Majesty's Government to insure through appropriate arrangements that use of the unitary method of taxation on a worldwide combined reporting basis is prohibited.

As originally drafted and submitted to the Senate for advice and consent to ratification, the U.S.-U.K. Tax Convention would have prohibited under Article 9(4) the use of such methods of foreign corporate taxation by both countries and by several States. In adopting its reservation to Article 9(4) in June of 1978, the Senate appeared to reach a consensus that domestic legislation, as an alternative to international treaty language, is preferable in regulating that conduct of the States which may affect foreign commerce. The terms of the Third Protocol, negotiated by the previous government of the United Kingdom and the United States to accommodate the Senate's reservation, is silent, of necessity, on the proper limits of the States' power to tax British multinational corporations.

Under the unitary method of taxation on a worldwide combined reporting basis, any one of the States of this Union has the opportunity unilaterally to establish tax liability for local subsidiaries of foreign multinational corporations. Although Congress alone has the power, under the Constitution, to "regulate Commerce with Foreign Nations," the States may incorrectly interpret the Senate's reservation to Article 9(4), and the Third Protocol to this Convention, as an invitation to establish tax policies applicable to foreign source income which are inconsistent or incompatible with broad National tax policies.

In the landmark case of *Japan Line, Ltd.* v. *County of Los Angeles*, No. 77-1378, decided April 30, 1979, the U.S. Supreme Court held that a State of this Union may not tax the instrumentalities of foreign commerce if the tax "... creates a substantial risk of international multiple taxation, and ... prevents the Federal government from 'speaking with one voice when regulating commercial relations with foreign Governments.'" (Slip Opinion 16). There is no doubt [p. 16] that the unitary method of taxation on a worldwide combined reporting basis creates a substantial risk of multiple taxation of international operations. Almost by definition, that method prevents the Federal Government from "speaking with one voice" in commercial relations with foreign governments.

There is pending in the Senate legislation which would remedy the situation. As introduced by Senator Mathias, S. 983 would define the outer limits of power of a State to apportion foreign source income to operations and activities within its jurisdiction. As a practical matter, Senator Mathias' bill in Section 303 would assure the power of a State to tax that foreign source income that is properly allocable under Section 482 of the Internal Revenue Code. Upon enactment of the relevant portions of Senator Mathias' bill, the risk of international multiple taxation by a State of this Union will be diminished, and the United States will "speak with one voice" as required by the Constitution.

If Congress does not act promptly to conform the foreign source tax policies of the States to national tax policy, the repercussions abroad could be severely damaging to U.S. interests. The precedent of unitary taxation on a worldwide combined reporting basis cannot be established by this country without probable retaliation by scores of countries around the world whose ambition may extend to those profits of U.S. multinational corporations generated beyond their jurisdictional limits.

If Congress acts to resolve the uncertainty created by the reservation to Article 9(4) as reflected in the Third Protocol, the American people can reasonably expect timely consideration of this important Tax Convention by the House of Commons. That is an objective which all Senators must share.

HOWARD H. BAKER, JR.

* * *

[p. 23] LETTER OF SUBMITTAL

THE PRESIDENT,
The White House.

DEPARTMENT OF STATE,
Washington, April 3, 1979.

THE PRESIDENT: I have the honor to submit to you, with a view to its transmission to the Senate for advice and consent to ratification, the Third Protocol further amending the Convention between the Government of the United States of America and the Government of the United Kingdom of Great Britain and Northern Ireland for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income and capital gains, signed at London on December 31, 1975, as amended by an exchange of notes dated April 13, 1976, and by Protocols signed at London on August 26, 1976 and March 31, 1977. The Third Protocol was signed at London on March 15, 1979.

The Senate gave advice and consent to ratification to the Convention, as amended, on June 27, 1978, with a reservation as to Article 9(4). Article 9(4) would have restricted the power of states of the United States to apply the unitary method of taxation to British multinational companies. The Senate's reservation stipulates that the provisions of Article 9(4) will not apply to any political subdivision or local authority of the United States.

The Third Protocol makes a number of changes to conform the language of the Convention to the Senate's reservation on Article 9(4). Execution of the Third Protocol by the United Kingdom and approval by the British House of Commons would confirm acceptance by the United Kingdom of the Senate's reservation with respect to Article 9(4) of the Convention.

The Third Protocol also modifies the definition of a "permanent establishment" in the case of activities carried on offshore in connection with the exploration and exploitation of the seabed and subsoil and their natural resources. Such activities are deemed to create a "permanent establishment" in a Contracting State if such activities were carried on in the State for at least 31 days in a 12 month period.

In addition, the Third Protocol provides a special limitation on the creditability by United States citizens or residents of the

United Kingdom petroleum revenue tax paid or accrued by them. This provision was included in the Third Protocol because of concern expressed during the Senate debate that the petroleum revenue tax (PRT) might be used by oil companies with North Sea operations to shelter oil related income from other countries. Under the provisions of the Third Protocol, the creditability of the PRF is limited by an amount determined with reference to United Kingdom source oil income.

[p. 24] The Third Protocol also makes a number of technical and clarifying changes to the provisions of the Convention dealing with the United States excise tax on insurance premiums, the taxation of remuneration for government service, dividends from dual resident corporations, and the period of time during which refunds relating to taxes paid in previous periods may be applied for.

A technical memorandum explaining in detail the provisions of the Third Protocol is being prepared by the Department of the Treasury and will be submitted to the Senate Foreign Relation Committee.

The Department of the Treasury, with the cooperation of the Department of State, was primarily responsible for the negotiation of the Third Protocol. It has the approval of both Departments.

Respectfully submitted.

CYRUS VANCE.

[p. 25] THIRD PROTOCOL FURTHER AMENDING THE CONVENTION BETWEEN THE GOVERNMENT OF THE UNITED STATES OF AMERICA AND THE GOVERNMENT OF THE UNITED KINGDOM OF GREAT BRITAIN AND NORTHERN IRELAND FOR THE AVOIDANCE OF DOUBLE TAXATION AND THE PREVENTION OF FISCAL EVASION WITH RESPECT TO TAXES ON INCOME AND CAPITAL GAINS, SIGNED AT LONDON ON 31 DECEMBER 1975.

The Government of the United States of America and the Government of the United Kingdom of Great Britain and Northern Ireland;

Desiring to conclude a third Protocol to amend the Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income and Capital Gains, signed at London on 31 December 1975, as amended by Notes exchanged at London on 13 April 1976 and by Protocols signed at London on 26 August 1976 and 31 March 1977 (hereinafter referred to as "the Convention");

Have agreed as follows:

ARTICLE I

(1) Paragraph (2) of Article 2 (Taxes covered) shall be deleted and replaced by the following:

"(2) The existing taxes to which this Convention shall apply are:

(*a*) in the case of the United States, the Federal income taxes imposed by the Internal Revenue Code and the tax on insurance premiums paid to foreign insurers; but (except as provided in paragraph (6) of Article 10 (Dividends)) excluding the accumulated earnings tax and the personal holding tax. The foregoing taxes covered are hereinafter referred to as "United States tax";

(*b*) in the case of the United Kingdom, the income tax, the capital gains tax, the corporation tax and the petroleum revenue tax. The foregoing taxes covered are hereinafter referred to as "United Kingdom tax"."

(2) Paragraph (3) or Article 2 (Taxes covered) shall be deleted and replaced by the following:

(3) This Convention shall also apply to any identical or substantially similar taxes which are imposed by a Contracting State after the date of signature of this Convention in addition to, or in place of, the existing taxes. The competent authorities of the Contracting States shall notify each other of any changes which have been made in their respective taxation laws."

(3) Paragraph (4) of Article 9 (Associated enterprises) shall be deleted and replaced by the following:

[p. 26] "(4) Except as specifically provided in this Article:

(*a*) where an enterprise doing business in one Contracting State:

(i) is a resident of the other Contracting State; or

(ii) is controlled, directly or indirectly, by an enterprise which is a resident of the other Contracting State; and

(*b*) where the enterprise which is a resident of the other Contracting State is a corporation, such corporation is neither:

(i) a controlled foreign corporation within the meaning of section 957 of the United States Internal Revenue Code of 1954 (as it may be amended from time to time without changing the principle thereof); nor

(ii) created or organised under the laws of the first-mentioned State or of any third State or controlled, directly or indirectly, by a corporation which is a resident of any third State;

then, in determining the tax liability of the first-mentioned enterprise in the State in which it does business, such State shall not take into account the income, deductions, receipts or outgoings of a related enterprise which is a resident of the other Contracting State or of an enterprise of any third State

which is related to the enterprise of the other Contracting State, except that this prohibition shall not apply where the first-mentioned enterprise is a resident of the first-mentioned Contracting State, to the extent that it owns, directly or indirectly, the capital of the related enterprise."

* * *

[p. 33] TECHNICAL EXPLANATION OF THE THIRD PROTOCOL SIGNED AT LONDON ON MARCH 15, 1979 (THE "THIRD PROTOCOL" OR THE "PROTOCOL") FURTHER AMENDING THE CONVENTION BETWEEN THE GOVERNMENT OF THE UNITED STATES OF AMERICA AND THE GOVERNMENT OF THE UNITED KINGDOM OF GREAT BRITAIN AND NORTHERN IRELAND FOR THE AVOIDANCE OF DOUBLE TAXATION AND THE PREVENTION OF FISCAL EVASION WITH RESPECT TO TAXES ON INCOME AND CAPITAL GAINS SIGNED AT LONDON, ON DECEMBER 31, 1975, AS AMENDED BY THE NOTES EXCHANGED AT LONDON ON APRIL 13, 1976, AND THE PROTOCOLS SIGNED AT LONDON ON AUGUST 25, 1976 AND MARCH 31, 1977 (THE CONVENTION AS AMENDED BY THE NOTES AND THE TWO PROTOCOLS BEING REFERRED TO AS THE "CONVENTION").

The Third Protocol contains seven articles which modify Articles 2 (Taxes covered), 7 (Business profits), 9 (Associated enterprises), 10 (Dividends), 19 (Government service), 23 (Elimination of double taxation), and 28 (Entry into force) of the Convention. In addition, Article VI of the Protocol adds a new Article 27A (Offshore activities) to the Convention. Set forth below is an explanation of each article of the Protocol.

ARTICLE I

Article I contains three paragraphs serving to conform the text of the Convention to the United States Senate's reservation which was made a part of its June 27, 1978 resolution of advice and consent to ratification. The references to income taxes imposed by political subdivisions or local authorities are deleted from

paragraphs (2) and (3) of Article 2 (Taxes covered) and from paragraph (4) of Article 9 (Associated enterprises). The other provisions of those paragraphs are restated. Taxes imposed by political subdivisions and local authorities remain subject to the provisions of Article 24 (Non-discrimination) of the Convention, by reason of paragraph (4) of Article 2 (Taxes covered).

* * *

[p. 43] APPENDIX C

WRITTEN RESPONSES BY WITNESSES TO QUESTIONS BY SENATORS AND COMMITTEE STAFF

DEPARTMENT OF THE TREASURY,
Washington, D.C., June 8, 1979.

HON. FRANK CHURCH,
Chairman, Committee on Foreign Relations,
U.S. Senate
Washington, D.C.

DEAR MR. CHAIRMAN: To follow-up my testimony at the June 6 hearings concerning the six tax conventions or protocols involving the United Kingdom, France, Hungary and Korea, I want to assure you that Article I of the Third Protocol of the proposed US-UK Income Tax Treaty gives full effect to the Senate's reservation on Article 9(4) of that treaty. Let me also assure you that there is no similar state tax issue in any of the other five treaties which were considered by the Committee yesterday.

Again let me emphasize our view that each of these treaties is important to the United States and that their prompt approval is desirable.

I am also enclosing answers to the written questions submitted to me by your staff at the hearings as well as copies of my answers to questions from Senator Helms and Senator Javits.

Sincerely,

DONALD C. LUBICK,
Assistant Secretary (Tax Policy).

Enclosures.

QUESTIONS FOR ASSISTANT SECRETARY FOR TAX POLICY
DONALD C. LUBRICK

* * *

[p. 45] *Question 5.* The U.S. Treasury, in 1977, finalized a "model convention" for international tax treaties, could you please explain the status of this model and in particular, any changes that have been made to it?

Answer. For many years the Treasury had used an informal "model" as a basis for negotiations. This model evolved and changed as the negotiators gained experience with it. In 1976 a decision was made to publish the U.S. model. Following the 1977 publication of the revised OECD Model Convention, the Treasury revised its model to conform it to the OECD Model, where possible, and the revised model was published in May of 1977.

The model is sent to potential treaty partners prior to the commencement of negotiations, and it normally serves as the discussion draft during the first round of negotiations. Many changes are made in the model during negotiations to reflect particular problems which arise in attempting to mesh two tax systems. Changes may be made to reflect the needs of the other country. For example, where negotiations are with a developing country, many of the model provisions (designed for treaties between two developed countries) are inappropriate. The U.S. negotiators are generally quite flexible in modifying the model for treaties with developing countries. These changes occur most frequently in the provisions dealing with permanent establishments or the taxation of personal service income, in which cases a somewhat lesser degree of economic contact or penetration is required for the host county to be able to tax the income of a resident of the other country. Similarly, with the taxation of dividends, interest, and royalties, less of a reduction in withholding tax rates is generally required of developing countries. The U.S. interest in these cases is to avoid rates which are so high as to generate excess foreign tax credits for U.S. income recipients.

Questions 6 and 7. In the third protocol proposed to the U.S.-U.K. Income Tax Treaty, the definition of permanent establishment has been changed. Please explain the basis of this change. Were the affected U.S. drilling companies contacted

concerning the proposed change? If they were contacted, please give the details of when, by whom, and what resulted from such contact. Why was the permanent establishment definition selected as the item to be changed in the tax area?

Answer. In our discussions with the British subsequent to the Senate reservation on Article 9(4) of the proposed treaty, the United Kingdom specifically requested the inclusion in the protocol of a provision clarifying their taxing rights with respect to exploration and exploitation connected activities. This requested clarification was not unusual in light of the original negotiations in 1975 over the permanent [p. 46] establishment definition. In those negotiations, the United States agreed to delete from the twelve month permanent establishment exclusion contained in subparagraph (2)(f) of the proposed treaty any reference to "an installation or drilling rig or ship used for the exploration or development of natural resources" as a result of the British insistence that there be no limitation on their right to tax such activities. This deletion left the application of the permanent establishment definition to these activities somewhat uncertain, although as the United Kingdom authorities believe, a strong argument exists that these activities could be taxed even without the clarification of the new protocol.

We agreed to the inclusion of this provision in the Third Protocol because it was reasonable to expect the British to request some additional concession for the loss of the benefits of Article 9(4); because the terms of the provisions were reasonable in light of our own statutory tax policy (we would generally tax these kinds of activities conducted in the United States, even if they were of a shorter duration than 30 days); and because it could be viewed as little more than a clarification of a reasonable interpretation taken by the British of their taxing rights under the proposed treaty without the the protocol provision.

The drilling industry was clearly aware of the precise terms of the protocol provision at least one month prior to the signing of the Protocol on March 15, 1979. On February 16, 1979, Mr. Arnold W. Bramlett, Chairman of the Accounting and Taxation Committee of the International Association of Drilling Contractors (IADC), wrote to the International Tax Counsel, Mr. H.

David Rosenbloom, expressing general concern over the provision. Subsequently, there were telephone conversations between Mr. Rosenbloom and Mr. Bramlett in which the Treasury sought specific information as to the nature of the activities and the harm which was alleged would occur. These requests were confirmed in a letter from Mr. Rosenbloom to Mr. Bramlett on March 5, 1979, still 10 days before the Protocol was signed. To date, the Treasury has not received from the IADC, or any of its members, specific information detailing any specific adverse effects of the protocol provision.

EXHIBIT 37H

INTERNATIONAL TAX TREATIES

HEARING
BEFORE THE
COMMITTEE ON FOREIGN RELATIONS

UNITED STATES SENATE

NINETY-SIXTH CONGRESS

FIRST SESSION
ON

SIX INTERNATIONAL TAX TREATIES AND PROTOCOLS

JUNE 6, 1979

Printed for the use of the Committee on Foreign Relations

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WASHINGTON : 1979

THIRD PROTOCOL TO THE UNITED STATES-
UNITED KINGDOM INCOME TAX TREATY

Question 13. Would you please summarize the British reaction to the reservation included in the Senate advice and consent to ratification last June 27, 1978, concerning Article 9(4).

Answer. The British tax authorities were unhappy with the Senate reservation concerning Article 9(4). They hoped that a modified version of Article 9(4) might be included in the treaty. When it became clear that there was no possibility of a modification which would be acceptable to all parties, they reluctantly agreed to seek Parliamentary approval of the treaty with the deletion of Article 9(4) but only after the Third Protocol is approved by the Senate. The British authorities view some of the provisions of the Third Protocol (particularly the North Sea permanent establishment rules) as a concession for the deletion of Article 9(4). We recently reconfirmed with the British their willingness to go forward with the treaty if the protocol is approved by the Senate.

Very strong objection has been raised by the U.K. business community to the deletion of Article 9(4). Many business and industrial groups in the U.K. have urged Parliament not to reapprove the treaty in the absence of the Article 9(4) provision.

The strength of these objections was confirmed by testimony at the June 6 hearings to the effect that there is a view among some Conservative Members of Parliament that the treaty should not be approved unless some solution can be found to the state taxation problem, albeit outside the treaty framework.

* * *

I. SCOPE OF THE TREATY

The first two articles of both the U.S. Model and the OECD Model define the personal scope of the treaty and the taxes covered. The differences in the scope of the two models are discussed below.

1. *Personal scope.* — In delimiting the personal scope of the treaty, the most significant departure in the U.S. Model from the OECD Model is the reservation to each Contracting State of the

right to tax its own residents and nationals as if the treaty did not come into effect. This provision overrides any other provision that would otherwise limit the authority of a Contracting State to apply its internal tax law to its citizens or residents. The only exceptions to this rule relate to provisions that are clearly intended to limit the authority of a Contracting State to tax its citizens or residents. The provisions of the treaty relating to the foreign tax credit, non-discrimination and the mutual agreement procedure are examples of those exceptions. The reason for this provision, known as the "saving clause", is that the United States views treaties as affecting a Contracting State's right to tax residents and citizens of the other Contracting State, and not as affecting its right to tax its own residents and citizens.

Under the saving clause, the United States retains it statutory right to tax its citizens and residents on worldwide income. The United States also retains the right to tax a former citizen on U.S. source income for a 10-year period if the former citizen renounced citizenship to avoid U.S. taxes.

In addition to this reservation of the right of each Contracting State to tax its own citizens and residents, the U.S. Model also clarifies that some of the treaty provisions apply to persons that are not residents of either of the Contracting States. The OECD Model makes this clarification in later provisions of the treaty.

2. *Taxes covered.* — With respect to taxes covered by the treaty, the U.S. Model contains two differences from the OECD Model. A minor difference is that the U.S. Model focuses on a specific list of taxes covered and does not contain a general discussion of those taxes. A more significant difference is that, except for purposes of the Non-Discrimination Article, income and capital taxes imposed by local subdivisions of the United States are not covered by the treaty. These local U.S. taxes are not covered because it is unlikely that the United States would consent to the ratification of any treaty provision that restricted the rights of the various states to impose their own taxes.

* * *

EXHIBIT 371

S. Hrg. 9
REVIEW OF UNITARY METHOD OF TAXATION

HEARING
BEFORE THE
SUBCOMMITTEE ON
TAXATION AND DEBT MANAGEMENT
OF THE COMMITTEE ON FINANCE

UNITED STATES SENATE
NINETY-NINTH CONGRESS

SECOND SESSION
ON

S. 1113 and S. 1974

SEPTEMBER 29, 1986

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For Release Upon Delivery
Expected at 9:30 a.m. EST
Monday, September 29, 1986

STATEMENT OF THE HONORABLE
J. ROGER MENTZ
ASSISTANT SECRETARY (TAX POLICY)
DEPARTMENT OF TREASURY
TO THE
SUBCOMMITTEE ON TAXATION AND
DEBT MANAGEMENT
OF THE
SENATE FINANCE COMMITTEE
UNITED STATES SENATE

Mr. Chairman and Members of the Committee:

Thank you for this opportunity to present the views of the Department of the Treasury on S. 1974, a bill introduced by Senator Pete Wilson that addresses state taxation of the world-wide income of corporations and their affiliates. In general, S. 1974 would prohibit states from levying corporate income taxes on a worldwide unitary basis, would require states to tax foreign source dividends in an equitable manner, and would provide additional federal assistance to the states for the administration and enforcement of their corporate income taxes. As you know, this legislation was drafted by the Treasury Department at the express direction of the President and was introduced last December with the full support of the Administration. Identical legislation was introduced in the House of Representatives as H.R. 3980.

I am pleased to report that, since the introduction of the legislation, Idaho, New Hampshire, Utah and, on September 5, California, have enacted "water's edge" legislation. The Administration applauds these states' actions. These state legislative developments go a long way toward resolving the difficult unitary tax issue. Moreover, they illustrate the successful operation of the Federal system. These and the other states that have moved away from the worldwide unitary tax system in recent years recognize that their interest, and the national interest, lies in a single,

coherent approach to taxing international income that minimizes tax-related impediments to international flows of investment capital.

We have not, however, reached the end of the road with respect to this issue. Though the economic impact is not great, three states (Alaska, Montana, and North Dakota) continue to impose tax on a worldwide unitary basis. As I will discuss below, we also have concerns regarding elements of the California legislation. We believe, however, that such significant progress has been made that restrictive Federal legislation is not warranted at this time. Rather, we believe that Congressional action on S. 1974 should be deferred until the remaining worldwide unitary states have a full opportunity to act, California has an opportunity to consider and respond to comments on its recently enacted legislation, and we have an opportunity to evaluate the actual operation of water's edge legislation passed by the several states when fully in effect.

We also do not believe that a treaty resolution of the unitary issue is necessary or appropriate at this time. Because a treaty would offer relief from worldwide unitary tax to foreign based multinationals while not addressing the inclusion of foreign dividends to domestic multinationals, a treaty resolution does not by itself satisfy the principle of ensuring competitive balance among similarly situated businesses. We therefore view a treaty approach to the issue as the least desirable of possible alternatives.

While we do not believe that restrictive federal legislation is called for at this time, the Administration has advocated broader federal support of state tax collection activities. States have moved away from the worldwide unitary method in part in reliance on the Administration's representations in this regard. To the extent possible without legislation, the Administration has already moved to provide greater assistance to the states. We continue to be committed to providing such federal support and believe that the portions of S. 1974 that are directed to that objective should be enacted at the earliest practicable time.

The progress made on this difficult issue is a tribute to the wisdom of President Reagan's decision in 1983 to seek a cooperative solution by convening a Worldwide Unitary Taxation Working Group, consisting of representatives from states, business and the Federal government, to address the issue. It is also a tribute to the leadership evidenced by the state officials and leaders of domestic and foreign-controlled multinationals that have together forged compromises in states across the country. We expect that these participants will continue to demonstrate the same leadership as we attempt to address the remaining concerns relating to the worldwide unitary tax issue.

In the remainder of my testimony I will discuss the background of the worldwide unitary issue, the proposed Federal solution, and concerns raised by the California legislation.

I. BACKGROUND

A. Separate Accounting Versus Worldwide Unitary Combination

The operation of a business enterprise across state or national boundaries requires each jurisdiction to determine what portion of the enterprise's income it will tax. The objective of each taxing jurisdiction should be to attribute to itself an amount of the income of the multijurisdictional enterprise that is appropriate in relation to the economic activity conducted in that jurisdiction. Failure of any of the taxing jurisdictions to assign the income to the respective jurisdictions of operation under a consistent accounting method may result in over-taxation . . . .

* * *

In response to the Working Group recommendations four states, Florida, Indiana, Oregon and Colorado, acted promptly to adopt acceptable water's edge legislation. Other states, however, moved more slowly. In particular, in 1985 the California legislature considered, but failed to adopt, legislation that would have limited that state's use of the worldwide unitary system of taxation.

Continued inaction by these states on the unitary issue after the Working Group deliberations resulted in even stronger foreign protests. Most seriously, in July 1985 the U.K. Parliament unanimously adopted Section 54, in its 1985 Finance Bill. This

provision permits the U.K. government to deny, on a unilateral and retroactive basis, the valuable Advance Corporation Tax refund benefit granted by the U.S.-U.K. bilateral tax treaty to U.S. corporations that own British subsidiaries. Although the U.K. has not yet invoked Section 54, the very existence of that provision and the possibility of its retroactive implementation has had a detrimental impact on the willingness of U.S. companies to repatriate earnings from their U.K. subsidiaries in accordance with the treaty provision as well as a detrimental impact on commercial relations between the United States and the United Kingdom.*

* * *

*The Treasury Department has serious concerns regarding Section 54. We believe that its existence is inconsistent with the U.S.-U.K. bilateral income tax treaty to the extent its threatened use causes U.S. taxpayers to refrain from claiming benefits under the treaty. Its actual implementation would be a clear violation of the treaty.

EXHIBIT 40GG

Income Tax Treaty United Kingdom

United Kingdom

Income tax treaty

Signed 12/31/75; entered into force 4/25/80; operative, generally, 1/1/75 (4/1/73 or 4/6/75) for refunds of tax on certain dividends paid to U.S.). Modified by notes exchanged on 4/13/76; protocol signed 8/26/76; second protocol signed 3/31/77; and third protocol signed 3/15/79; all entered into force and operative as above.

Article 1 — Personal Scope

(1) Except as specifically provided herein, this Convention is applicable to persons who are residents of one or both of the Contracting States.

(2) A corporation which is both a resident of the United Kingdom within the meaning of paragraph (1)(a)(ii) of Article 4 (Fiscal Residence), and a resident of the United States within the meaning of paragraph (1)(b)(ii) of Article 4 shall not be entitled to claim any relief or exemption from tax provided by this Convention except that such corporation may claim the benefits of paragraph (2) of Article 8 (Shipping and Air Transport), of Article 23 (Elimination of Double Taxation) with respect to paragraph (1)(c) thereof and the petroleum revenue tax referred to in paragraph (2)(b) of Article 2 (Taxes Covered), of Article 24 (Non-Discrimination) and of Article 28 (Entry into Force) and the provisions of paragraph (7) of Article 11 (Interest) shall apply to it.

(3) Notwithstanding any provision of this Convention except paragraph (4) of this Article, a Contracting State may tax its residents (as determined under Article 4 (Fiscal Residence)) and its nationals as if this Convention had not come into effect.

(4) Nothing in paragraph (3) of this Article shall affect the application by a Contracting State of:

(a) paragraph (4) of Article 4 (Fiscal Residence), paragraph (2) of Article 8 (Shipping and Air Transport), and

Articles (9) (Associated Enterprises), 23 (Elimination of Double Taxation), 24 (Non-Discrimination) and 25 (Mutual Agreement Procedure); and

(b) Articles 19 (Government Service), 20 (Teachers), 21 (Students and Trainees), and 27 (Effect on Diplomatic and Consular Officials and Domestic Laws), with respect to individuals who are neither nationals of, nor have immigrant status in, that State.

Article 2 — Taxes Covered

(1) This Convention shall apply to taxes on income imposed by each Contracting State and as hereinafter provided to taxes imposed by its political subdivisions or local authorities.

(2) The existing taxes to which this Convention shall apply are:

(a) in the case of the United States, the Federal income taxes imposed by the Internal Revenue Code and the tax on insurance premiums paid to foreign insurers; but (except as provided in paragraph (6) of Article 10 (Dividends)) excluding the accumulated earnings tax and the personal holding tax. The foregoing taxes covered are hereinafter referred to as "United States tax";

(b) in the case of the United Kingdom, the income tax, the capital gains tax, the corporation tax and the petroleum revenue tax. The foregoing taxes covered are hereinafter referred to as "United Kingdom tax"."

(3) This Convention shall also apply to any identical or substantially similar taxes which are imposed by a Contracting State after the date of signature of this Convention in addition to, or in place of, the existing taxes. The competent authorities of the Contracting States shall notify each other of any changes which have been made in their respective taxation laws.

(4) For the purposes of Article 24 (Non-discrimination), this Convention shall also apply to taxes of every kind and description imposed by each Contracting State, or by its political subdivisions or local authorities.

Article 3 — General Definitions

(1) In this Convention, unless the context otherwise requires:

(a) the term "corporation" means a United States corporation, a United Kingdom corporation, or any body corporate or other entity of a third State which is treated as a body corporate for tax purposes by both Contracting States;

(b) the term "United States corporation" means:

(i) a corporation (or any unincorporated entity treated as a corporation for United States tax purposes) which is created or organized under the laws of the United States or any state thereof or the District of Columbia; and

(ii) the term "United Kingdom corporation" means any body corporate or unincorporated association created or organized under the laws of the United Kingdom, but does not include a partnership, a local authority, or a local authority association;

(c) the term "person" includes an individual, a corporation, a partnership, an estate, a trust and any other body of persons;

(d) the term "enterprise of a Contracting State" means an industrial or commercial undertaking carried on by a resident of a Contracting State;

(e) the term "international traffic" means any transport by a ship or aircraft operated by an enterprise of a Contracting State, except when the ship or aircraft is operated solely between places in the other Contracting State;

(f) the term "competent authority" means:

(i) in the case of the United States, the Secretary of the Treasury or his delegate, and

(ii) in the case of the United Kingdom, the Commissioners of Inland Revenue or their authorized representatives;

(g) the term "United States" means:

(i) the United States of America; and

(ii) when used in a geographical sense, the States thereof and the District of Columbia. Such term also includes: (aa) the territorial sea thereof, and (bb) the seabed and subsoil of the submarine areas adjacent to the coast thereof, but beyond the territorial sea, over which the United States exercises sovereign rights, in accordance with international law, for the purpose of exploration for and exploitation of the natural resources of such areas, but only to the extent that the person, property, or activity to which the Convention is being applied is connected with such exploration or exploitation;

(h)

(i) the term "United Kingdom" means Great Britain and Northern Ireland, including any area outside the territorial sea of the United Kingdom which in accordance with international law has been or may hereafter be designated, under the laws of the United Kingdom concerning the Continental Shelf, as an area within which the rights of the United Kingdom with respect to the seabed and subsoil and their natural resources may be exercised;

(i) the term "Contracting State" means the United States or the United Kingdom, as the context requires;

(j) the term "nationals" means:

(i) in relation to the United Kingdom, all citizens of the United Kingdom and Colonies, British subjects under Sections 2, 13(1) or 16 of the British Nationality Act 1948, and British subjects by virtue of Section 1 of the British Nationality Act 1965, provided they are partial within the meaning of the Immigration Act 1971, so far as these provisions are in force on the date of entry into force of this Convention or have been modified only in minor respects so as not to affect their general character;

(ii) in relation to the United States, United States citizens.

(2) As regards the application of this Convention by a Contracting State any term not otherwise defined shall, unless the context otherwise requires and subject to the provisions of Arti-

cle 25 (Mutual Agreement Procedure), have the meaning which it has under the laws of that Contracting State relating to the taxes which are the subject of this Convention.

Article 4 — Fiscal Residence

(1) For the purposes of this Convention:

(a) the term "resident of the United Kingdom" means:

(i) any person, other than a corporation, resident in the United Kingdom for the purposes of United Kingdom tax; but in the case of a partnership, estate, or trust, only to the extent that the income derived by such partnership, estate, or trust is subject to United Kingdom tax as the income of a resident, either in its hands or in the hands of its partners or beneficiaries; and

(ii) a corporation whose business is managed and controlled in the United Kingdom;

(b) the term "resident of the United States" means:

(i) any person, other than a corporation, resident in the United States for the purposes of United States tax; but in the case of a partnership, estate, or trust, only to the extent that the income derived by such partnership, estate, or trust is subject to United States tax as the income of a resident, either in its hands or in the hands of its partners or beneficiaries; and

(ii) a United States corporation.

(2) Where by reason of the provisions of paragraph (1) an individual is a resident of both Contracting States, then the individual's tax status shall be determined as follows:

(a) the individual shall be deemed to be a resident of the Contracting State in which he has a permanent home available to him. If the individual has a permanent home available to him in both Contracting States or in either of the Contracting States, he shall be deemed to be a resident of the Contracting State with which his personal and economic relations are closest (centre of vital interests);

(b) If the Contracting State in which the individual's centre of vital interests is located cannot be determined, he shall be deemed to be a resident of that Contracting State in which he has an habitual abode;

(c) If the individual has an habitual abode in both Contracting States or in neither of them, he shall be deemed to be a resident of the Contracting State of which he is a national; and

(d) If the individual is a national of both Contracting States or of neither of them, the competent authorities of the Contracting States shall settle the question by mutual agreement.

(3) Where by reason of the provisions of paragraph (1) an estate or trust may be a resident of both Contracting States, the competent authorities of the Contracting States may settle the question of residence by mutual agreement.

(4) A marriage before 1 January 1974 between a woman who is a United States national and a man domiciled within the United Kingdom shall be deemed to have taken place on 1 January 1974 for the purpose of determining her domicile on or after 6 April 1976 for United Kingdom tax purposes.

(5) Where under any provison of this Convention income arising in one of the Contracting States is relieved from tax in that Contracting State and, under the law in force in the other Contracting State a person, in respect of the said income, is subject to tax by reference to the amount thereof which is remittted to or received in that other Contracting State and not by reference to the full amount thereof, then the relief to be allowed under this Convention in the first-mentioned Contracting State shall apply only to so much of the income as is remitted to or received in the other Contracting State.

Article 5 — Permanent Establishment

(1) For the purposes of this Convention, the term "permanent establishment" means a fixed place of business through which the business of an enterprise is wholly or partly carried on.

(2) The term "permanent establishment" shall include especially:

(a) a branch;

(b) an office;

(c) a factory;

(d) a workshop;

(e) a mine, oil or gas well, quarry, or other place of extraction of natural resources; and

(f) a building or construction or installation project which exists for more than 12 months.

(3) Notwithstanding the provisions of the preceding paragraphs, the term "permanent establishment" shall be deemed not to include a fixed place of business used solely for one or more of the following activities:

(a) the storage, display, or delivery of goods or merchandise belonging to the enterprise;

(b) the maintenance of a stock of goods or merchandise belonging to the enterprise for the purpose of storage, display or delivery;

(c) the maintenance of a stock of goods or merchandise belonging to the enterprise for the purpose of processing by another person;

(d) the maintenance of a fixed place of business for the purpose of purchasing goods or merchandise, or for collecting information, for the enterprise;

(e) the maintenance of a fixed place of business for the purpose of advertising, for the supply of information, for scientific research, or for similar activities which have a preparatory or auxiliary character, for the enterprise; or

(f) a building or construction or installation project which does not exist for more than 12 months.

(4) A person acting in a Contracting State on behalf of an enterprise of the other Contracting State — other than an agent of an independent status to whom paragraph (5) applies — shall be deemed to have a permanent establishment of the enterprise in the first-mentioned State if such person has, and habitually

exercises in that State, an authority to conclude contracts in the name of the enterprise, unless the contracts are confined to the activities described in paragraph (3) of this Article.

(5) An enterprise of a Contracting State shall not be deemed to have a permanent establishment in the other Contracting State merely because it carries on business in that other State through a broker, general commission agent or any other agent of independent status, where such persons are acting in the ordinary course of their business.

(6) The fact that a corporation which is a resident of a Contracting State controls or is controlled by a corporation which is a resident of the other Contracting State, or which carries on business in that other State (whether through a permanent establishment or otherwise), shall not of itself constitute either corporation a permanent establishment of the other.

Article 6 — Income From Immovable Property (Real Property)

(1) Income from immovable property (real property), including income from agriculture or forestry, may be taxed in the Contracting State in which such property is situated.

(2) The term "immovable property" shall be defined in accordance with the law of the Contracting State in which the property in question is situated. The term shall in any case include usufruct of immovable property and rights to variable or fixed payments as consideration for the working of, or the right to work, mineral deposits, sources and other natural resources; ships, boats and aircraft shall not be regarded as immovable property.

(3) The provisions of paragraph (1) shall apply to income derived from the direct use, letting, or use in any other form of immovable property.

Article 7 — Business Profits

(1) The business profits of an enterprise of a Contracting State shall be taxable only in that State unless the enterprise carried on business in the other Contracting State through a permanent establishment situated therein. If the enterprise carries on business as aforesaid, the business profits of the enterprise may be taxed in that other State but only so much of them as is attributable to that permanent establishment.

(2) Subject to the provisions of paragraph (3), where an enterprise of a Contracting State carries on business in the other Contracting State through a permanent establishment situated therein, there shall in each Contracting State be attributed to that permanent establishment the profits which it might be expected to make if it were a distinct and separate enterprise engaged in the same or similar activities under the same or similar conditions and dealing wholly independently with the enterprise of which it is a permanent establishment.

(3) In the determination of the profits of a permanent establishment, there shall be allowed as deductions those expenses which are incurred for the purposes of the permanent establishment, including a reasonable allocation of executive and general administrative expenses, research and development expenses, interest, and other expenses incurred for the purposes of the enterprise as a whole (or the part thereof which includes the permanent establishment), whether incurred in the State in which the permanent establishment is situated or elsewhere.

(4) No business profits shall be attributed to a permanent establishment by reason of the mere purchase by that permanent establishment of goods or merchandise for the enterprise.

(5) For the purposes of the preceding paragraphs, the profits to be attributed to the permanent establishment shall be determined by the same method year by year unless there is good and sufficient reason to the contrary.

(6) Where profits include items of income which are dealt with separately in other Articles of this Convention, then the provisions of those Articles shall not be affected by the provisions of this Article.

(6A) The United States tax on insurance premiums paid to foreign insurers shall not be imposed on insurance on reinsurance premiums which are the receipts of a business of insurance carried on by an enterprise of the United Kingdom whether or not

that business is carried on through a permanent establishment in the United States.

(7) For the purposes of this Convention, "business profits" includes, but is not limited to, income derived from manufacturing, mercantile, banking, insurance, agricultural, fishing or mining activities, the operation of ships or aircraft, the furnishing of services, the rental of tangible personal (movable) property, and the rental or licensing of cinematographic films or films or tapes used for radio or television broadcasting or from copyrights thereof. Such term also includes any other income effectively connected with a permanent establishment which the recipient, being a resident of one of the Contracting States, has in the other Contracting State. Such term does not include the performance of personal services by an individual either as an employee or in an independent capacity.

Article 8 — Shipping and Air Transport

(1) Profits derived by an enterprise of a Contracting State from the operation of ships or aircraft in international traffic shall be taxable only in that State.

(2) Notwithstanding any other provision of this Convention, profits which a national of the United States not resident in the United Kingdom or a United States corporation derives from operating ships documented or aircraft registered under the laws of the United States shall be exempt from United Kingdom tax.

(3) For the purpose of this Article, profits from the operation of ships or aircraft include profits derived from the rental on a bareboat basis of ships or aircraft if such rental income is incidental to other income described in paragraph (1) of this Article.

(4) Notwithstanding the provisions of Article 7 (Business Profits), profits of an enterprise of a Contracting State from the use, maintenance or rental of containers (including trailers and related equipment for the transport of containers) used for the transport of goods or merchandise shall be taxable only in that State, except where such containers are used for the transport of

goods or merchandise solely between places within the other Contracting State.

(5) The provisions of this Article shall apply also to profits derived by an enterprise of a Contracting State from participation in a pool, a joint business or an international operating agency.

(6) Gains derived by an enterprise of a Contracting State from the alienation of ships, aircraft or containers owned and operated by the enterprise, the income from which is taxable only in that State, shall be taxed only in that State.

Article 9 — Associated Enterprises

(1) Where an enterprise of a Contracting State is related to another enterprise and conditions are made or imposed between the two enterprises in their commercial or financial relations which differ from those which would have been made between independent enterprises, then any income, deductions, receipts, or outgoings which would, but for those conditions, have been attributed to one of the enterprises but by reason of those conditions have not been so attributed, may be taken into account in computing the profits or losses of that enterprise and taxed accordingly.

(2) Where any income, deductions, receipts, or outgoings which have been taken into account in one Contracting State in computing the profits or losses of an enterprise are also taken into account in the other Contracting State in computing the profits and losses of a related enterprise in accordance with paragraph (1) of this Article, then the first-mentioned State shall make such adjustment as may be appropriate to the amount of tax charged on those profits in that State.

(3) If one Contracting State disagrees with the amount of any income, deductions, receipts, or outgoings, taken into account in computing profits or losses in the other in accordance with paragraph (1), the two Contracting States shall endeavor to reach agreement in accordance with the procedure in Article 25 (Mutual Agreement Procedure).

(4) Except as specifically provided in this Article:

(a) where an enterprise doing business in one Contracting State:

(i) is a resident of the other Contracting State; or

(ii) is controlled, directly or indirectly, by an enterprise which is a resident of the other Contracting State; and

(b) where the enterprise which is a resident of the other Contracting State is a corporation, such corporation is neither:

(i) a controlled foreign corporation within the meaning of section 957 of the United States Internal Revenue Code of 1954 (as it may be amended from time to time without changing the principle thereof); nor

(ii) created or organised under the laws of the first-mentioned State or of any third State or controlled, directly or indirectly, by a corporation which is a resident of any third State;

then, in determining the tax liability of the first-mentioned enterprise in the State in which it does business, such State shall not take into account the income, deductions, receipts or outgoings of a related enterprise which is a resident of the other Contracting State or of an enterprise of any third State which is related to the enterprise of the other Contracting State, except that this prohibition shall not apply where the first-mentioned enterprise is a resident of the first-mentioned Contracting State, to the extent that it owns, directly or indirectly, the capital of the related enterprise."

(5) For the purposes of this Convention, an enterprise is related to another enterprise if either enterprise directly or indirectly controls the other, or if any third person or persons (related to each other or acting together) control both.

Article 10 — Dividends

(1) Dividends derived from a corporation which is a resident of a Contracting State by a resident of the other Contracting State may be taxed in the other Contracting State. However, such

dividends may be taxed in the Contracting State of which the corporation paying the dividends is a resident, but if the beneficial owner is a resident of the other Contracting State, the tax so charged shall not exceed 15 per cent of the gross amount of the dividends.

(2) As long as an individual resident in the United Kingdom is entitled under United Kingdom law to a tax credit in respect of dividends paid by a corporation which is resident in the United Kingdom, paragraph (1) of this Article shall not apply. In these circumstances, dividends derived from a corporation which is a resident of a Contracting State by a resident of the other Contracting State may be taxed in the other Contracting State. However, such dividends may be taxed in the Contracting State of which the corporation paying the dividends is a resident, but if the beneficial owner is a resident of the other Contracting State, the tax so charged shall not exceed the tax provided in sub-paragraphs (a) and (b) below:

(a) In the case of dividends paid by a corporation which is a resident of the United Kingdom:

(i) to a United States corporation which either alone or together with one or more associated corporations controls, directly or indirectly, at least 10 per cent of the voting stock of the corporation which is a resident of the United Kingdom paying the dividend, the United States corporation shall be entitled to a payment from the United Kingdom of a tax credit equal to one-half of the tax credit to which an individual resident in the United Kingdom would have been entitled had he received the dividend, subject to the deduction withheld from such payment and according to the laws of the United Kingdom of an amount not exceeding 5 per cent of the aggregate of the amount of value of the dividend and the amount of the tax credit paid to such corporation;

(ii) in all other cases, the resident of the United States to whom such dividend is paid shall be entitled to a payment from the United Kingdom of the tax credit to which an individual resident in the United Kingdom would have been entitled had he received the dividend, subject to the deduc-

tion withheld from such payment and according to the laws of the United Kingdom of an amount not exceeding 15 per cent of the aggregate of the amount or value of the dividend and the amount of the tax credit paid to such resident;

(iii) the aggregate of the amount or value of the dividend and the amount of the tax credit referred to in sub-paragraphs (a)(i) and (ii) of this paragraph paid by the United Kingdom to the United States corporation or other resident (without reduction for the 5 or 15 per cent deduction, as the case may be, by the United Kingdom) shall be treated as a dividend for United States tax credit purposes.

(b) In the case of dividends paid by a United States corporation:

(i) to a corporation which is a resident of the United Kingdom and controls, directly or indirectly, at least 10 per cent of the voting stock of the United States corporation paying such dividend, the tax charged by the United States shall not exceed 5 per cent of the gross amount of the dividend;

(ii) in all other cases, the tax charged by the United States on payment of a dividend to a resident of the United Kingdom shall not exceed 15 per cent of the gross amount of the dividend.

For the purposes of this paragraph, two corporations shall be deemed to be associated if one controls directly or indirectly more than 50 per cent of the voting power in the other corporation, or a third corporation controls more than 50 per cent of the voting power in both of them.

(3) The term "dividends" for United Kingdom tax purposes includes any item which under the law of the United Kingdom is treated as a distribution and for United States tax purposes includes any item which under the law of the United States is treated as a distribution out of earnings and profits.

(4) Paragraph (1) or (2), as the case may be, shall not apply if the person deriving the dividends, being a resident of a Contracting State, carries on business in the other Contracting State

through a permanent establishment situated therein, or performs in that other State independent personal services from a fixed base situated therein, and the holding in respect of which the dividends are paid is effectively connected with such permanent establishment or fixed base. In such a case the provisions of Articles 7 (Business Profits), 14 (Independent Personal Services), or 17 (Artistes and Athletes), as the case may be, shall apply.

(5) Where a corporation which is a resident of a Contracting State (and not a resident of the other Contracting State) derives profits or income from the other Contracting State, that other State may not impose any tax on the dividends paid by the corporation, except insofar as such dividends are paid to a resident of that other State (and where that other State is the United States, to a national of the United States) or insofar as the holding in respect of which the dividends are paid is effectively connected with a permanent establishment or fixed base situated in that other State, even if the dividends paid consist wholly or partly of profits or income arising in that other State.

(6) A corporation which is a resident of the United Kingdom shall be exempt from United States tax on its accumulated or undistributed earnings, profits, income or surplus, if individuals (other than nationals of the United States) who are residents of the United Kingdom control, directly or indirectly, throughout the last half of the taxable year, more than 50 per cent of the entire voting power in such corporation.

(7)

(a) If the beneficial owner of a dividend being a resident of a Contracting State owns 10 per cent or more of the class of shares of a corporation in respect of which the dividend is paid, then paragraph (1), or as the case may be paragraph (2), of this Article shall not apply to the dividend to the extent that it can have been paid only out of profits which the corporation paying the dividend earned or other income which it received in a period ending 12 months or more before the relevant date. For the purposes of this paragraph the term "relevant date" means the date on which the beneficial owner of the dividend

became the owner of 10 per cent or more of the class of shares in question.

(b) Paragraphs (1) and (2) of this Article shall not apply if:

(i) the recipient of the dividend is exempt from tax thereon in the United States; and

(ii) the dividend is paid in such circumstances that, if the recipient were a resident of the United Kingdom exempt from United Kingdom tax, the exemption would be limited or removed.

Provided that this paragraph shall not apply if the beneficial owner of the dividend shows that the shares were acquired for bona fide commercial reasons and not primarily for the purposes of securing the benefit of this Article.

Article 11 — Interest

(1) Interest derived and beneficially owned by a resident of the United Kingdom shall be exempt from tax by the United States.

(2) Interest derived and beneficially owned by a resident of the United States shall be exempt from tax by the United Kingdom.

(3) The term "interest" as used in this Article means income from Government securities, bonds or debentures, whether or not secured by mortgage and whether or not carrying a right to participate in profits, and other debt claims of every kind as well as all other income assimilated to income from money lent by the taxation law of the State in which the income arises but subject to the provisions of paragraph (7) of this Article shall not include any income which is treated as a distribution under the provisions of Article 10 (Dividends). Penalty charges for late payment shall not be regarded as interest for the purpose of this Article.

(4) The provisions of paragraphs (1) and (2) shall not apply if the person deriving the interest, being a resident of a Contracting State, carries on business in the other Contracting State through a permanent establishment situated therein, or performs in that other State independent personal services from a fixed base situated therein, and the debt claim in respect of which the

interest is paid is effectively connected with such permanent establishment or fixed base. In such a case, the provisions of Article 7 (Business Profits), Article 14 (Independent Personal Services), or Article 17 (Artistes and Athletes), as the case may be, shall apply.

(5) Where, owing to a special relationship between the payer and the person deriving the interest or between both of them and some other person, the amount of the interest paid exceeds for whatever the reason the amount which would have been paid in the absence of such relationship, the provisions of this Article shall apply only to the last-mentioned amount. In that case, the excess part of the payments shall remain taxable according to the law of each Contracting State, due regard being had to the other provisions of this Convention.

(6) Whether or not a resident of a Contracting State derives profits or income from the other Contracting State, the other State may not impose any tax on the interest paid by that resident, except insofar as such interest is paid to a resident of that other State (and where that other State is the United States, to a national of the United States) or insofar as the debt claim in respect of which the interest is paid is effectively connected with a permanent establishment or a fixed base of the person deriving interest situated in that other State.

(7) Any provision in the law of either Contracting State relating only to interest paid to a non-resident corporation shall not operate so as to require such interest paid to a resident of the other Contracting State to be treated as a distribution by the corporation paying such interest. The preceding sentence shall not apply to interest paid to a corporation of one Contracting State in which more than 50 per cent of the voting power is controlled, directly or indirectly, by a person or persons who are residents of the other Contracting State.

(8) The provisions of paragraph (2) of this Article shall not apply if the recipient of the interest is exempt from tax on such income in the United States and such recipient sells or makes a contract to sell the holding from which such interest is derived

within three months of the date such recipient acquired such holding.

Article 12 — Royalties

(1) Royalties derived and beneficially owned by a resident of the United Kingdom shall be exempt from tax by the United States

(2) Royalties derived and beneficially owned by a resident of the United States shall be exempt from tax by the United Kingdom.

(3) The term "royalties" as used in this Article (a) means payments of any kind received as a consideration for the use of, or the right to use, any copyright of literary, artistic or scientific work (but not including cinematographic films or films or tapes used for radio or television broadcasting); any patent, trade mark, design or model plan, secret formula or process, or other like right or property, or for information concerning industrial, commercial or scientific experience; and (b) shall include gains derived from the alienation of any such right or property which are contingent on the productivity, use, or disposition thereof; including the supply of assistance of an ancillary and subsidiary nature furnished as a means of enabling the application or enjoyment of any such right or property.

(4) The provisions of paragraphs (1) and (2) of this Article shall not apply if the person deriving the royalties, being a resident of a Contracting State, carries on business in the other Contracting State in which the royalties arise, through a permanent establishment situated therein, or performs in that other State independent personal services from a fixed base situated therein, and the right or property in respect of which the royalties are paid is effectively connected with such permanent establishment or fixed base. In such a case the provisions of Article 7 (Business Profits), Article 14 (Independent Personal Services), or Article 17 (Artistes and Athletes), as the case may be, shall apply.

(5) Where, owing to a special relationship between the payer and the person deriving the royalties or between both of them and some other person, the amount of the royalties paid exceeds for whatever reason the amount which would have been paid in the absence of such relationship, the provisions of this Article shall apply only to the last-mentioned amount. In that case, the excess part of the payments shall remain taxable according to the law of each Contracting State, due regard being had to the other provisions of this Convention.

Article 13 — Capital Gains

Except as provided in Article 8 (Shipping and Air Transport) of this Convention, each Contracting State may tax capital gains in accordance with the provisions of its domestic law.

Article 14 — Independent Personal Services

Income derived by an individual who is a resident of one of the Contracting States from the performance of personal services in an independent capacity may be taxed in that State. Such income may also be taxed in the other Contracting State if:

(a) the individual is present in that other State for a period or periods exceeding in the aggregate 183 days in the tax year concerned, but only so much thereof as is attributable to services performed in that State, or

(b) the individual has a fixed base regularly available to him in that other State for the purpose of performing his activities, but only so much thereof as is attributable to services performed in that State.

Article 15 — Dependent Personal Services

(1) Subject to the provisions of Articles 18 (Pensions) and 19 (Government Service), salaries, wages and other similar remuneration derived by a resident of a Contracting State in respect of an employment shall be taxable only in that State unless the employment is exercised in the other Contracting State. If the employment is so exercised, such remuneration as is derived therefrom may be taxed in that other State.

(2) Notwithstanding the provisions of paragraph (1), remuneration derived by a resident of a Contracting State in respect of an employment exercised in the other Contracting State shall be taxable only in the first-mentioned State if:

(a) the recipient is present in that other State for a period not exceeding in the aggregate 183 days in the tax year concerned; and

(b) the remuneration is paid by, or on behalf of, an employer who is not a resident of that other State; and

(c) the remuneration is not borne as such by a permanent establishment or a fixed base which the employer has in that other State.

(3) Notwithstanding the preceding provisions of this Article, remuneration in respect of an employment as a member of the regular complement of a ship or aircraft in international traffic may be taxed by the Contracting State of which the employer operating the ship or aircraft is a resident.

Article 16 — Investment or Holding Companies

The provisions of Articles 10 (Dividends), 11 (Interest) or 12 (Royalties) of this Convention shall not apply to a corporation which is a resident of one of the Contracting States and which derives dividends, interest, or royalties arising within the other Contracting State if:

(a) (i) the tax imposed on the corporation by the first-mentioned Contracting State in respect of such dividends, interest or royalties is substantially less than the tax generally imposed by that State on corporate profits; or

(ii) the corporation is a resident of the United States and receives more than eighty per cent of its gross income from sources outside the United States as determined by and for the period prescribed in sections 861(a)(1)(B) and (a)(2)(A) of the internal Revenue Code of 1954, as they may be amended from time to time in minor respects so as not to affect their general principle; and

(b) 25 per cent or more of the capital of such corporation is owned directly or indirectly by one or more persons who are not individual residents of the first-mentioned Contracting State and are not nationals of the United States.

Article 17 — Artistes and Athletes

(1) Notwithstanding the provisions of Articles 14 (Independent Personal Services) and 15 (Dependent Personal Services), income derived by entertainers, such as theatre, motion picture, radio or television artistes, and musicians, and by athletes, from their personal activities as such may be taxed in the Contracting State in which these activities are exercised, except where the amount of the gross receipts derived by an entertainer or athlete, including expenses reimbursed to him or borne on his behalf, from such activities do not exceed 15,000 United States dollars or its equivalent in pounds sterling in the tax year concerned.

(2) Where income in respect of personal activities as such of an entertainer or athlete accrues not to that entertainer or athlete himself but to another person, that income may, not withstanding the provisions of Articles 7 (Business Profits), 14 Independent Personal Services), and 15 (Dependent Personal Services), be taxed in the Contracting State in which the activities of the entertainer or athlete are exercised. For the purposes of the preceding sentence, income of an entertainer or athlete shall be deemed not to accrue to another person if it is established that neither the entertainer or athlete, nor persons related thereto, participate directly or indirectly in the profits of such other person in any manner, including the receipt of deferred remuneration, bonuses, fees, dividends, partnership distributions or other distributions.

Article 18 — Pensions

(1) Subject to the provisions of paragraph (2) of Article 19 (Government Service), any pension in consideration of past employment and any annuity paid to an individual who is a resident of a Contracting State shall be taxed only in that State.

(2) Alimony paid to an individual who is a resident of one of the Contracting States by an individual who is a resident of the other Contracting State shall be exempt from tax in the other Contracting State.

(3) The term "annuity" means a stated sum payable periodically at stated times, during life or during a specified or ascertainable period of time, under an obligation to make the payments in return for adequate and full consideration in money or money's worth.

Article 19 — Government Service

(1)

(a) Remuneration, other than a pension, paid by a Contracting State to any individual in respect of services rendered to that State shall be taxable only in that State.

(b) However, such remuneration shall be taxable only in the other Contracting State if the services are rendered in that State and the recipient is a resident and a national of that State.

(2)

(a) Any pension paid by a Contracting State or a political subdivision or a local authority thereof to any individual in respect of services rendered to that State or subdivision or local authority thereof shall be taxable only in that State.

(b) However, such pension shall be taxable only in the other Contracting State if the recipient is a national of and a resident of that State.

(3) The provisions of Articles 14 (Independent Personal Services), 15 (Dependent Personal Services), 17 (Artists and Athletes), and 18 (Pensions), as the case may be, shall apply to remuneration and pensions in respect of services rendered in connection with any business carried on by or on behalf of one of the Contracting States or a political subdivision or a local authority thereof.

Article 20 — Teachers

(1) A professor or teacher who visits one of the Contracting States for a period not exceeding two years for the purpose of teaching or engaging in research at a university, college or other recognized educational institution in that Contracting State and who was immediately before that visit a resident of the other Contracting State, shall be exempted from tax by the first-mentioned Contracting State on any remuneration for such teaching or research for a period not exceeding two years from the date he first visits that State for such purpose.

(2) The exemption provided in this Article may be applied by the Contracting State in which the teaching or research is performed to current payments to such professor or teacher in anticipation of fulfilment of the requirements of paragraph (1) or by way of withholding and refund, but in either case exemption shall be conditioned upon fulfilment of the requirements of paragraph (1).

(3) This Article shall only apply to income from research if such research is undertaken by the professor or teacher in the public interest and not primarily for the benefit of some other private person or persons.

Article 21 — Students and Trainees

Payments which a student or business apprentice who was immediately before visiting a Contracting State a resident of the other Contracting State and who is present in the first-mentioned Contracting State for the purpose of his full-time education or training receives for the purpose of his maintenance, education or training shall not be taxed in that State, provided that such payments are made to him from sources outside that State.

Article 22 — Other Income

(1) Items of income of a resident of a Contracting State, wherever arising, not dealt with in the foregoing Articles of this Convention shall be taxable only in that State. The preceding sentence shall not apply to income paid out of trusts.

(2) The provisions of paragraph (1) shall not apply if the person deriving the income, being a resident of a Contracting State, carries on business in the other Contracting State through a permanent establishment situated therein, or performs in that other State independent personal services from a fixed base situated therein, and the right or property in respect of which the income is paid is effectively connected with such permanent establishment or fixed base. In such a case the provisions of Article 7 (Business Profits), Article 14 (Independent Personal Services), or Article 17 (Artists and Athletes), as the case may be, shall apply.

Article 23 — Elimination of Double Taxation

(1) In accordance with the provisions and subject to the limitations of the law of the United States (as it may be amended from time to time without changing the general principle hereof), the United States shall allow to a resident or national of the United States as a credit against the United States tax the appropriate amount of tax paid to the United Kingdom; and, in the case of a United States corporation owning at least 10 per cent of the voting stock of a corporation which is a resident of the United Kingdom from which it receives dividends in any taxable year, the United States shall allow credit for the appropriate amount of tax paid to the United Kingdom by that corporation with respect to the profits out of which such dividends are paid. Such appropriate amount shall be based upon the amount of tax paid to the United Kingdom, but the credit shall not exceed the limitations (for the purpose of limiting the credit to the United States tax on income from sources outside of the United States) provided by United States law for the taxable year. For the purpose of applying the United States credit in relation to tax paid to the United Kingdom.

(a) the taxes referred to in paragraphs (2)(b) and (3) of Article 2 (Taxes Covered) shall be considered to be income taxes;

(b) the amount of 5 or 15 per cent, as the case may be, withheld under paragraph (2)(a)(i) or (ii) of Article 10 (Dividends) from the tax credit paid by the United Kingdom shall be treated as an income tax imposed on the recipient of the dividend; and

(c) that amount of tax credit referred to in paragraph (2)(a)(i) of Article 10 (Dividends) which is not paid to the United States corporation but to which an individual resident in the United Kingdom would have been entitled had he received the dividend shall be treated as an income tax imposed on the corporation paying the dividend.

(2) Subject to the provisions of the law of the United Kingdom regarding the allowance as a credit against United Kingdom tax of tax payable in a territory outside the United Kingdom (as it may be amended from time to time without changing the general principle hereof):

(a) United States tax payable under the laws of the United States and in accordance with the present Convention, whether directly or by deductions, on profits or income from sources within the United States (excluding in the case of a dividend, tax payable in respect of the profits out of which the dividend is paid) shall be allowed as a credit against any United Kingdom tax computed by reference to the same profits or income by reference to which the United States tax is computed;

(b) in the case of a dividend paid by a United States corporation to a corporation which is resident in the United Kingdom and which controls directly or indirectly at least 10 per cent of the voting power in the United States corporation, the credit shall take into account (in addition to any United States tax creditable under (a)) the United States tax payable by the corporation in respect of the profits out of which such dividend is paid.

(3) For the purposes of the preceding paragraphs of this Article, income or profits derived by a resident of a Contracting State which may be taxed in the other Contracting State in accordance with this Convention shall be deemed to arise from sources within the other Contracting State, except that where the United States taxes on the basis of citizenship, the United Kingdom shall not be bound to give credit to a United States

national who is resident in the United Kingdom on income from sources outside the United States as determined under the laws of the United Kingdom and the United States shall not be bound to give credit for United Kingdom tax on income received by such national from sources outside the United Kingdom, as determined under the laws of the United States.

(4) Notwithstanding sub-paragraph (a) of paragraph (1) of this Article, the amount of United Kingdom petroleum revenue tax allowable as a credit against United States tax shall be limited to the amount attributable to United Kingdom source taxable income in the following way, namely:

(a) The amount of United Kingdom petroleum revenue tax on income from the extraction of minerals from oil or gas wells in the United Kingdom to be allowed as a credit for a taxable year shall not exceed the amount, if any, by which the product of the maximum statutory United States tax rate applicable to a corporation for such taxable year and the amount of such income exceeds the amount of other United Kingdom tax on such income.

(b) The lesser of (i) the amount of United Kingdom petroleum revenue tax on income from the extraction of minerals from oil or gas wells in the United Kingdom that is not allowable as a credit under the preceding sub-paragraph, or (ii) 2 per cent of such income for the taxable year shall be deemed to be income taxes paid or accrued in the two preceding or five succeeding taxable years, to the extent not deemed paid or accrued in a prior taxable year, and shall be allowable as a credit in the year in which it is deemed paid or accrued subject to the limitation in sub-paragraph (a) above.

(c) The provisions of sub-paragraphs (a) and (b) shall apply, separately, *mutatis mutandis* (but with the deletion, in the case of (b), of the words "the lesser of (i)" and "or (ii) 2 per cent of such income for the taxable year"), to the amount of United Kingdom petroleum revenue tax on income from initial transportation, initial treatment and initial storage of minerals from oil or gas wells in the United Kingdom.

Article 24 — Nondiscrimination

(1) Individuals who are nationals of a Contracting State and who are residents of the other Contracting State shall not be subjected in that other State to any taxation or any requirement connected therewith which is other or more burdensome than the taxation and connected requirements to which nationals of that other State in the same circumstances are or may be subjected.

(2) The taxation on a permanent establishment which an enterprise of a Contracting State has in the other Contracting State shall not be less favourably levied in that other State than the taxation levied on enterprises of that other State carrying on the same activities.

(3) Subject to the provisions of paragraph (4) of this Article, interest, royalties and other disbursements paid by an enterprise of a Contracting State to a resident of the other Contracting State shall, if reasonable in amount, be deductible for the purpose of determining the taxable profits of such enterprise under the same conditions as if they had been paid to a resident of the first-mentioned State. For the purposes of this paragraph, the term "other disbursements" shall include charges for amounts expended by such residents for the purposes of such enterprise, including a reasonable allocation of executive and general administrative expenses (except to the extent representing the expenses of a type of activity which is not for the benefit of such enterprise, but constitutes "stewardship" or "over-seeing" functions undertaken for such resident's own benefit as an investor in the enterprise), research and development in respect of which such enterprise has the benefits under a cost and risk sharing agreement and other expenses incurred by such resident for the benefit of a group of related enterprises including such enterprise.

(4) Paragraph (3) shall not apply to any interest, royalties, or other disbursements to which the provisions of Article 9 (Associated Enterprises), paragraphs (5) and (7) of Article 11 (Interest) or paragraph (5) of Article 12 (Royalties) apply.

(5) Enterprises of a Contracting State, the capital of which is wholly or partly owned or controlled, directly or indirectly, by one or more residents of the other Contracting State shall not be

subjected in the first-mentioned contracting state to any taxation or any requirement connected therewith which is other or more burdensome than the taxation and connected requirements to which other similar enterprises of the first-mentioned State are or may be subjected.

(6) Nothing contained in this Article shall be construed as obliging either Contracting State to grant to individuals not resident in that State any of the personal allowances and reliefs which are granted to individuals so resident.

Article 25 — Mutual Agreement Procedure

(1) Where a resident or national of a Contracting State considers that the actions of one or both of the Contracting States result or will result in taxation not in accordance with this Convention, he may, notwithstanding the remedies provided by the national laws of those States, present his case to the competent authority of the Contracting State of which he is a resident or national.

(2) The competent authority shall endeavour, if the objection appears to it to be justified and if it is not itself able to arrive at an appropriate solution, to resolve the case by mutual agreement with the competent authority of the other Contracting State, with a view to the avoidance of taxation not in accordance with the Convention. Where an agreement has been reached, a refund as appropriate shall be made to give effect to the agreement.

(3) The competent authorities of the Contracting States shall endeavour to resolve by mutual agreement any difficulties or doubts arising as to the interpretation or application of the Convention. In particular the competent authorities of the Contracting States may reach agreement on:

(a) the attribution of income, deductions, credits, or allowances of an enterprise of a Contracting State to its permanent establishment situated in the other Contracting State;

(b) the allocation of income, deductions, credits, or allowances between persons;

(c) the nature of particular items of income;

(d) the meaning of terms not otherwise defined in this Convention;

(e) the place where a particular item of income has its source;

(f) the elimination of double taxation in respect of income paid out of trusts.

(4) The competent authorities of the Contracting States may communicate with each other directly for the purpose of reaching agreement as contemplated by this Convention.

Article 26 — Exchange of Information and Administrative Assistance

(1) The competent authorities of the Contracting States shall exchange such information (being information available under the respective taxation laws of the Contracting States) as is necessary for carrying out the provisions of this Convention or for the prevention of fraud or the administration of statutory provisions against legal avoidance in relation to the taxes which are the subject of this Convention. Any information so exchanged shall be treated as secret but may be disclosed to persons (including a court or administrative body) concerned with the assessment, collection, enforcement or prosecution in respect of taxes which are the subject of this Convention. No information shall be exchanged which would disclose any trade, business, industrial or professional secret or any trade process.

(2) Each of the Contracting States will endeavour to collect on behalf of the other Contracting State such amounts as may be necessary to ensure that relief granted by this Convention from taxation imposed by such other Contracting State does not enure to the benefit of persons not entitled thereto. The United Kingdom will be regarded as fulfilling this obligation by the continuation of its existing arrangements for ensuring that relief from taxation imposed by the laws of the United States does not enure to the benefits of persons not entitled thereto.

(3) Paragraph (2) of this Article shall not impose upon either of the Contracting States the obligation to carry out administrative measures which are of a different nature from those used in the collection of its own tax, or which would be contrary to its sovereignty, security or public policy. In determining the administrative measures to be carried out, each Contracting State may take into account the administrative measures and practices of the other Contracting State in recovering taxes on behalf of the first-mentioned Contracting State.

(4) The competent authorities of the Contracting States shall consult with each other for the purpose of co-operating and advising in respect of any action to be taken in implementing this Article.

Article 27 — Effect on Diplomatic and Consular Officials and Domestic Laws

(1) Nothing in this Convention shall affect the fiscal privileges of diplomatic or consular officials under the general rules of international law or under the provisions of special agreements.

(2) This Convention shall not restrict in any manner any exclusion, exemption, deduction, credit, or other allowances now or hereafter accorded by the laws of either Contracting State.

Article 27A — Offshore Activities

(1) Notwithstanding the provisions of Article 5 (Permanent establishment) and Article 14 (Independent personal services), a person who is a resident of a Contracting State and carries on activities in the other Contracting State in connection with the exploration or exploitation of the seabed and sub-soil and their natural resources situated in that other Contracting State shall be deemed to be carrying on in respect of those activities a business in that other Contracting State through a permanent establishment or fixed base situated therein.

(2) The provisions of paragraph (1) shall not apply where the activities are carried on for a period not exceeding 30 days in aggregate in any 12 month period. However, for the purpose of

this paragraph, activities carried on by any enterprise related to another enterprise shall be regarded as carried on by the enterprise to which it is related if the activities in question are substantially the same as those carried on by the last-mentioned enterprise.

(3) The provisions of Article 8 (Shipping and air transport) shall not apply to a drilling rig or any vessel the principal function of which is the performance of activities other than the transportation of goods or passengers.

Article 28 — Entry Into Force

(1) This Convention shall be ratified and the instruments of ratification shall be exchanged at Washington as soon as possible.

(2) This Convention shall enter into force immediately after the expiration of thirty days following the date on which the instruments of ratification are ~~exchanged~~ and shall thereupon have effect:

~~(a)~~ in the Untied Kingdom:

(i) in relation to any dividend to which subparagraph (2)(a)(ii) of Article 10 (Dividends) applies, in respect of income tax and payment of tax credit, for any year of assessment beginning on or after 6 April 1973. A dividend paid on or after 1 April 1973 and before 6 April 1973 shall be treated for tax credit purposes as paid on 6 April 1973;

(ii) in relation to paragraph (4) of Article 4 (Fiscal Residence), for any year of assessment beginning on or after 6 April 1976;

(iii) in relation to sub-paragraph (2)(a)(i) of Article 10 (Dividends) and any other provision (sic) of this Convention, in respect of income tax and payment of tax credit and in respect of capital gains tax, for any year of assessment beginning on or after 6 April 1975;

(iv) in respect of corporation tax, for any financial year beginning on or after 1 April 1975; and

(v) in respect of petroleum revenue tax, for any chargeable period beginning on or after 1 January 1975;

(b) in the United States:

(i) in respect of credits against United States tax allowed under paragraph (1) of Article 23 (Elimination of Double Taxation), for taxes paid to the United Kingdom on or after 1 April 1973;

(ii) in respect of tax withheld at the source, for amounts paid or credited on or after 1 January 1975; and

(iii) in respect of other taxes, for taxable years beginning on or after 1 January 1975.

(3) Subject to the provisions of paragraph (4) of this Article the Convention between the United Kingdom of Great Britain and Northern Ireland and the United States of America for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income signed at Washington on 16 April 1945, as amended by the Supplementary Protocol signed at Washington on 6 June 1946, by the Supplementary Protocol signed at Washington on 25 May 1954, by the Supplementary Protocol signed at Washington on 19 August 1957 and by the Supplementary Protocol signed at London on 17 March 1966 (hereinafter referred to as "the 1945 Convention"), shall cease to have effect in respect of taxes to which this Convention in accordance with the provisions of paragraph (2) of this Article applies.

(4) Where any provision of the 1945 Convention would have afforded any greater relief from tax any such provision as aforesaid shall continue to have effect:

(a) in the United Kingdom, for any year of assessment or financial year and

(b) in the United States, for any taxable year beginning in either case, before 1 January 1976.

(5) The 1945 Convention shall terminate on the last date on which it has effect in accordance with the foregoing provisions of this Article.

(6) This Convention shall not affect any Agreement in force extending the 1945 Convention in accordance with Article XXII thereof.

(7) Notwithstanding any provisions of the respective domestic laws of the Contracting States imposing time limits for applications for relief from tax, an application for relief under the provisions of this Convention shall have effect, and any consequential refunds of tax made, if the application is made to the competent authority concerned within three years of the end of the calendar year in which this Convention enters into force.

Article 29 — Termination

(1) This Convention shall remain in force indefinitely but either of the Contracting States may, on or before 30 June in any year after the year 1980, give to the other Contracting State, through diplomatic channels notice of termination and, in such event, the present Convention shall cease to be effective:

(a) in respect of United States tax, for the taxable years beginning on or after 1 January in the year next following that in which such notice is given;

(b)

(i) in respect of United Kingdom income tax and capital gains tax, for any year of assessment beginning on or after 6 April in the year next following that in which such notice is given;

(ii) in respect of United Kingdom corporation tax, for any financial year beginning on or after April 1 in the year next following that in which such notice is given;

(iii) in respect of United Kingdom petroleum revenue tax, for any chargeable period beginning on or after 1 January in the year next following that in which such notice is given.

(2) The termination of the present Convention shall not have the effect of reviving any treaty or arrangement abrogated by the present Convention or by treaties previously concluded between the Contracting States.

EXHIBIT 42

[Exchange of Notes between Honorable Allen J. MacEachen, Deputy Prime Minister and Minister of Finance of Canada and G. William Miller, Secretary of the United States Treasury, dated September 26, 1980.]

September 26, 1980

The Honorable
Allan J. MacEachen,
Deputy Prime Minister and
Minister of Finance of Canada

Sir:

I have the honor to acknowledge receipt of your note of September 26, 1980, which reads as follows:

"I have the honour to refer to the Convention between Canada and the United States of America with Respect to Taxes on Income and on Capital, signed today, and to confirm certain understandings reached between the two Governments with respect to the Convention.

1. In French, the term "societe" also means a "corporation" within the meaning of Canadian law.

2. The competent authorities of each of the Contracting States shall review the procedures and requirements for an organization of the other Contracting State to establish its status as a religious, scientfic, literary, educational or charitable organization entitled to exemption under paragraph I of Article XXI (Exempt Organizations), or as an eligible recipient of the charitable contributions or gifts referred to in paragraphs 5 and 6 of Article XXI, with a view to avoiding duplicate application by such organizations to the administering agencies of both Contracting States.

If a Contracting State determines that the other Contracting State maintains procedures to determine such status and rules for qualification that are compatible with such procedures and rules of the first-mentioned Contracting State, it is contemplated that such first-mentioned Contracting State shall accept the certification of the administering agency of the other Contracting State as to such status for the purpose of making the necessary determinations under paragraphs 1, 5 and 6 of Article XXI.

It is further agreed that the term "family," as used in paragraphs 5 and 6 of Article XXI, means an individual's brothers and sisters (whether by whole or half-blood, or by adoption), spouse, ancestors, lineal descendants and adopted descendants.

3. It is the position of Canada that the so-called "unitary apportionment" method used by certain states of the United States to allocate income to United States offices or subsidiaries of Canadian companies results in inequitable taxation and imposes excessive administrative burdens on Canadian companies doing business in those states. Under that method the profit of a Canadian company on its United States business is not determined on the basis of arm's-length relations but is derived from a formula taking account of the income of the Canadian company and its world-wide subsidiaries as well as the assets, payroll and sales of all such companies. For a Canadian multinational company with many subsidiaries in different countries to have to submit its books and records for all of these companies to a state of the United States imposes a costly burden. It is understood that the Senate of the United States has not consented to any limitation on the taxing jurisdiction of the states by a treaty and that a provision which would have restricted the use of unitary apportionment in the case of United Kingdom corporations was recently rejected by the Senate. Canada continues to be concerned about this issue as it affects Canadian multinationals. If an acceptable provision on this subject can be devised, the United States agrees to reopen discussions with Canada on this subject.

4. I have the honour to propose to you that the present Note and your reply thereto shall constitute an agreement between our two Governments on these matters."

I confirm these understandings on behalf of the Government of the United States of America. These understandings constitute an agreement between our two Governments on this matter, which will enter into force on the date of entry into force of the Convention between the Government of the United States of

American and the Government of Canada with Respect to Taxes on Income and on Capital which was signed today.

Accept, Sir, the renewed assurances of my highest consideration.

(Signed by: G. William Miller
Secretary of the Treasury)

EXHIBIT 43

Income Tax Treaty-France

IN WITNESS WHEREOF, the respective plenipotentiaries have signed the present Protocol and affixed thereto their seals.

DONE at Washington in duplicate, in the English and French languages, both texts being equally authoritative, this 24th day of November, 1978.

For the President of the United States of America:

George S. Vest
Assistant Secretary of State
for European Affairs

For the President of the French Republic:

Francois de Laboulaye
Ambassador of France

Excellency:

In connection with the Protocol signed today, I should like to state our understanding with respect to two important unresolved issues and certain other matters concerning the application of the Protocol.

1. The United States takes the position that the tax credit (*avoir fiscal*) available to French investors in French corporations should extend on a nondiscriminatory basis to United States investors in French corporations. Under the terms of the Protocol signed in 1970 to the income tax convention between our two countries, the *avoir fiscal* is extended to United States portfolio investors. But in the absence of a similar extension to United States direct investors, the United States Government considers that the French tax credit system discriminates against investments made in France through the intermediary of a United States parent corporation, as compared to investments made by a French parent corporation.

We recognize the revenue concerns of France with respect to this issue and are prepared to accept, in the case of dividends from French subsidiaries to United States parent corporations, one half of the credit available to French shareholders less the 5 percent withholding tax at source allowed by the treaty (Article 9).

We are very concerned that the Government of France is not able to agree at this time to extend one half of the *avoir fiscal* to United States direct investors. We have agreed to conclude the Protocol without such a provision only because the change in French tax law which takes effect January 1, 1979 would otherwise subject United States citizens residing in France to double taxation, and we do not want them to be so penalized. We appreciate, however, that the Government of France will continue considering this issue and agrees to reopen discussions on the subject of the *avoir fiscal* as soon as feasible, and in any event if the credit is extended in full or in part to direct investors of other countries.

His Excellency
Francois de Laboulaye
Ambassador of France

2. It is the position of the Government of France that the so-called "unitary apportionment" method used by certain states of the United States to allocate income to the United States offices or subsidiaries of French corporations, results in inequitable taxation and imposes excessive administrative burdens on French corporations doing business in those states. Under that method the profit of a French company on its United States business is not determined on the basis of arm's length relations but is derived from a formula taking account of the income of the French company and its worldwide subsidiaries as well as the assets, payroll, and sales of all such companies.

For a French multinational corporation with many subsidiaries in different countries to have to submit its books and records for all of these corporations to a United States state, in English, imposes a costly burden.

It is understood that the Senate of the United States has not consented to any limitation on the taxing jurisdiction of the states by treaty and that a provision which would have restricted the use of unitary apportionment in the case of United Kingdom corporations was recently rejected by the Senate. The Government of France continues to be concerned about this issue as it affects French multinationals. If an acceptable provision on this subject

can be devised, the United States agrees to reopen discussions with France on this subject.

3. The Explanatory Note issued by the French and American Governments will cease to have effect for periods to which this Protocol applies. With respect to the taxation of American residents in France under this Convention, the two governments have agreed that:

a. Contributions to pension, profit-sharing, and other retirement plans which qualify under the United States Internal Revenue Code will not be considered income to an employee and will be deductible from the income of a self-employed individual, to the extent that such contributions are required by the terms of the plan and are comparable to similar French arrangements;

b. Payments received by the beneficiary in respect of the plans referred to in (a) will be included in income for French tax purposes, to the extent not exempt under subparagraph (2)(a)(ii)(c) of Article 23 of the Convention, at the time when, and to the extent that, such payments are considered gross income under the Internal Revenue Code;

c. Benefits received by reason of exercise of stock options will be considered compensation for French tax purposes at the time and to the extent the exercise of the option or disposition of stock gives rise to ordinary income for United States tax purposes;

d. United States state and local income taxes imposed in respect of income from personal services and any other business income (except income which is exempt from French tax under the Convention) shall be allowed as business expenses;

e. The French Government will attempt to reach a reasonable solution with American residents of France regarding the taxation of employer-provided benefits which are not considered income by the United States;

f. In applying the provisions of French law referred to by paragraph 2(c) of Article 23, the French Government clarified how the exemption with progression provision applies. The tax due is that proportion of the tax on total income which taxable (non-exempt) income bears to total (exempt plus taxable) in-

come. For example, if a taxpayer has a total income of $20,000 of which by reason of this Convention only $12,000 is taxable by France, the French tax will be 60 percent (12,000/20,000) of the tax computed on a total income of $20,000.

If this is in accord with your understanding, I would appreciate a confirmation from you to this effect.

Accept, Excellency, the renewed assurances of my highest consideration.

George S. Vest
Assistant Secretary
for European Affairs

* * *

EXHIBIT 44

MODEL DOUBLE TAXATION CONVENTION ON INCOME AND ON CAPITAL

Report
of the OECD Committee
on Fiscal Affairs

1977

ORGANISATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT
PARIS

The Organisation for Economic Co-operation and Development (OECD) was set up under a Convention signed in Paris on 14th December, 1960, which provides that the OECD shall promote policies designed:

— to achieve the highest sustainable economic growth and employment and a rising standard of living in Member countries, while maintaining financial stability, and thus to contribute to the development of the world economy;

— to conribute to sound economic expansion in Member as well as non-member countries in the process of economic development;

— to contribute to the expansion of world trade on a multilateral, on-discriminatory basis in accordance with international obligations.

The Members of OECD are Australia, Belgium, Canada, Denmark, Finland, France, the Federal Republic of Germany, Greece, Iceland, Ireland, Italy, Japan, Luxembourg, the Netherlands, New Zealand, Norway, Portugal, Spain, Sweden, Switzerland, Turkey, the United Kingdom and the United States.

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NOTE: In order to make it possible to compare the 1977 Model Convention with the 1963 Draft Convention, the text of the latter is reproduced at the end of this volume (Appendix III).

[p. 23] TITLE OF THE CONVENTION

Convention between (State A) and (State B) for the avoidance of double taxation with respect to taxes on income and on capital

PREAMBLE OF THE CONVENTION

NOTE: The Preamble of the Convention shall be drafted in accordance with the constitutional procedure of both Contracting States.

[p. 24] CHAPTER I

SCOPE OF THE CONVENTION

* * *

Article 2

TAXES COVERED

1. This Convention shall apply to taxes on income and on capital imposed on behalf of a Contracting State or of its political subdivisions or local authorities, irrespective of the manner in which they are levied.

2. There shall be regarded as taxes on income and on capital all taxes imposed on total income, on total capital, or on elements of income or of capital, including taxes on gains from the alienation of movable or immovable property, taxes on the total amounts of wages or salaries paid by enterprises, as well as taxes on capital appreciation.

3. The existing taxes to which the Convention shall apply are in particular:

a) (in State A): ....

b) (in State B): ....

4. The Convention shall apply also to any identical or substantially similar taxes which are imposed after the date of signature of the Convention in addition to, or in place of, the existing taxes. At the end of each year, the competent authorities of the Contracting States shall notify each other of changes which have been made in their respective taxation laws.

[p. 25] CHAPTER II

DEFINITIONS

* * *

[p. 26] *Article 5*

PERMANENT ESTABLISHMENT

1. For the purposes of this Convention, the term "permanent establishment" means a fixed place of business through which the business of an enterprise is wholly or partly carried on.

2. The term "permanent establishment" includes especially:

a) a place of management;

b) a branch;

c) an office;

d) a factory;

e) a workshop, and

f) a mine, an oil or gas well, a quarry or any other place of extraction of natural resources.

3. A building site or construction or installation project constitutes a permanent establishment only if it lasts more than twelve months.

4. Notwithstanding the preceding provisions of this Article, the term "permanent establishment" shall be deemed not to include:

a) the use of facilities solely for the purpose of storage, display or delivery of goods or merchandise belonging to the enterprise;

b) the maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of storage, display or delivery;

c) the maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of processing by another enterprise;

d) the maintenance of a fixed place of business solely for the purpose of purchasing goods or merchandise or of collecting information, for the enterprise;

[p. 27] *e*) the maintenance of a fixed place of business solely for the purpose of carrying on, for the enterprise, any other activity of a preparatory or auxiliary character;

f) the maintenance of a fixed place of business solely for any combination of activities mentioned in sub-paragraphs a) to e), provided that the overall activity of the fixed place of business resulting from this combination is of a preparatory or auxiliary character.

5. Notwithstanding the provisions of paragraphs 1 and 2, where a person — other than an agent of an independent status to whom paragraph 6 applies — is acting on behalf of an enterprise and has, and habitually exercises, in a Contracting State an authority to conclude contracts in the name of the enterprise, that enterprise shall be deemed to have a permanent establishment in that State in respect of any activities which that person undertakes for the enterprise, unless the activities of such person are limited to those mentioned in paragraph 4 which, if exercised through a fixed place of business, would not make this fixed place of business a permanent establishment under the provisions of that paragraph.

6. An enterprise shall not be deemed to have a permanent establishment in a Contracting State merely because it carries on business in that State through a broker, general commission agent or any other agent of an independent status, provided that such persons are acting in the ordinary course of their business.

7. The fact that a company which is a resident of a Contracting State controls or is controlled by a company which is a resident of the other Contracting State, or which carries on business in that other State (whether through a permanent establishment or otherwise), shall not of itself constitute either company a permanent establishment of the other.

[p. 28] CHAPTER III

TAXATION OF INCOME

* * *

Article 7

BUSINESS PROFITS

1. The profits of an enterprise of a Contracting State shall be taxable only in that State unless the enterprise carries on business in the other Contracting State through a permanent establishment situated therein. If the enterprise carries on business as aforesaid, the profits of the enterprise may be taxed in the other State but only so much of them as is attributable to that permanent establishment.

2. Subject to the provisions of paragraph 3, where an enterprise of a Contracting State carries on business in the other Contracting State through a permanent establishment situated therein, there shall in each Contracting State be attributed to that permanent establishment the profits which it might be expected to make if it were a distinct and separate enterprise engaged in the same or similar activities under the same or similar conditions and dealing wholly independently with the enterprise of which it is a permanent establishment.

[p. 29] 3. In determining the profits of a permanent establishment, there shall be allowed as deductions expenses which are incurred for the purposes of the permanent establishment, including executive and general administrative expenses so incurred, whether in the State in which the permanent establishment is situated or elsewhere.

4. Insofar as it has been customary in a Contracting State to determine the profits to be attributed to a permanent establishment on the basis of an apportionment of the total profits of the enterprise to its various parts, nothing in paragraph 2 shall preclude that Contracting State from determining the profits to be taxed by such an apportionment as may be customary; the method of apportionment adopted shall, however, be such that the result shall be in accordance with the principles contained in this Article.

5. No profits shall be attributed to a permanent establishment by reason of the mere purchase by that permanent establishment of goods or merchandise for the enterprise.

6. For the purposes of the preceding paragraphs, the profits to be attributed to the permanent establishment shall be determined by the same method year by year unless there is good and sufficient reason to the contrary.

7. Where profits include items of income which are dealt with separately in other Articles of this Convention, then the provisions of those Articles shall not be affected by the provisions of this Article.

* * *

[p. 30] *Article 9*

ASSOCIATED ENTERPRISES

1. Where

a) an enterprise of a Contracting State participates directly or indirectly in the management, control or capital of an enterprise of the other Contracting State, or

b) the same persons participate directly or indirectly in the management, control or capital of an enterprise of a Contracting State and an enterprise of the other Contracting State,

and in either case conditions are made or imposed between the two enterprises in their commercial or financial relations which differ from those which would be made between independent enterprises, then any profits which would, but for those conditions, have accrued to one of the enterprises, but, by reason of those conditions, have not so accrued, may be included in the profits of that enterprise and taxed accordingly.

2. Where a Contracting State includes in the profits of an enterprise of that State — and taxes accordingly — profits on which an enterprise of the other Contracting State has been charged to tax in that other State and the profits so included are profits which would have accrued to the enterprise of the first-mentioned State, if the conditions made between the two enter-

prises had been those which would have been made between independent enterprises, then that other State shall make an appropriate adjustment to the amount of the tax charged therein on those profits. In determining such adjustment, due regard shall be had to the other provisions of this Convention and the competent authorities of the Contracting States shall if necessary consult each other.

* * *

[p. 41] CHAPTER VI

SPECIAL PROVISIONS

Article 24

NON-DISCRIMINATION

1. Nationals of a Contracting State shall not be subjected in the other Contracting State to any taxation or any requirement connected therewith, which is other or more burdensome than the taxation and connected requirements to which nationals of that other State in the same circumstances are or may be subjected. This provision shall, notwithstanding the provisions of Article 1, also apply to persons who are not residents of one or both of the Contracting States.

2. The term "nationals" means:

a) all individuals possessing the nationality of a Contracting State;

b) all legal persons, partnerships and associations deriving their status as such from the laws in force in a Contracting State.

3. Stateless persons who are residents of a Contracting State shall not be subjected in either Contracting State to any taxation or any requirement connected therewith, which is other or more burdensome than the taxation and connected requirements to which nationals of the State concerned in the same circumstances are or may be subjected.

4. The taxation on a permanent establishment which an enterprise of a Contracting State has in the other Contracting State

shall not be less favourably levied in that other State than the taxation levied on enterprises of that other State carrying on the same activities. This provision shall not be construed as obliging a Contracting State to grant to residents of the other Contracting State any personal allowances, reliefs and reductions for taxation purposes on account of civil status or family responsibilities which it grants to its own residents.

5. Except where the provisions of paragraph 1 of Article 9, paragraph 6 of Article 11, or paragraph 4 of Article 12, apply, interest, royalties and other disbursements paid by an enterprise of a Contracting State to a resident of the other Contracting State shall, for the purpose of determining the taxable profits of such enterprise, be deductible under the same conditions as if they had been paid to a resident of the first-mentioned State. Similarly, any debts of an enterprise of a Contracting State to a resident of the other Contracting State shall, for the purpose of determining the taxable capital of such enterprise, be deductible under the same conditions as if they had been contracted to a resident of the first-mentioned State.

[p. 42] 6. Enterprises of a Contracting State, the capital of which is wholly or partly owned or controlled, directly or indirectly, by one or more residents of the other Contracting State, shall not be subjected in the first-mentioned State to any taxation or any requirement connected therewith which is other or more burdensome than the taxation and connected requirements to which other similar enterprises of the first-mentioned State are or may be subjected.

7. The provisions of this Article shall, notwithstanding the provisions of Article 2, apply to taxes of every kind and description.

* * *

[p. 45] *ANNEX II*

COMMENTARIES ON THE ARTICLES OF THE MODEL CONVENTION

[p. 49] COMMENTARY ON ARTICLE 2 CONCERNING TAXES COVERED BY THE CONVENTION

This Article is intended to make the terminology and nomenclature relating to the taxes covered by the Convention more acceptable and precise, to ensure identification of the Contracting States' taxes covered by the Convention, to widen as much as possible the field of application of the Convention by including, as far as possible, and in harmony with the domestic laws of the Contracting States, the taxes imposed by their political subdivisions or local authorities, and to avoid the necessity of concluding a new convention whenever the Contracting States' domestic laws are modified by means of the periodical exchange of lists and through a procedure for mutual consultation.

Paragraph 1

2. This paragraph defines the scope of application of the Convention: taxes on income and on capital; the term "direct taxes" which is far too imprecise has therefore been avoided. It is immaterial on behalf of which authorities such taxes are imposed; it may be the State itself or its political subdivisions or local authorities (constituent States, regions, provinces, "départements", cantons, districts, "arrondissements", "Kreise", municipalities or groups of municipalities, etc.). The method of levying the taxes is equally immaterial: by direct assessment or by deduction at the source, in the form of surtaxes or surcharges, or as additional taxes ("centimes additionnels"), etc.

Paragraph 2

3. This paragraph gives a definition of taxes on income and on capital. Such taxes comprise taxes on total income and on elements of income, on total capital and on elements of capital. They also include taxes on profits and gains derived from the alienation of movable or immovable property, as well as taxes on capital appreciation. Finally, the definition extends to taxes on the total amounts of wages or salaries paid by undertakings ("payroll taxes"; in Germany "Lohnsummensteuer"; in France, "taxe sur les salaires"). Social security charges, or any other charges paid

where there is a direct connection between the levy and the individual benefits to be received, shall not be regarded as "taxes on the total amount of wages".

4. Clearly a State possessing taxing powers — and it alone — may levy the taxes imposed by its legislation together with any duties or charges accessory to them: increases, costs, interest, etc. It has not been considered necessary to specify this in the Article, as it is obvious that in the levying of the tax the accessory duties or charges depend on the same rule as the principal duty.

[p. 50] 5. The Article does not mention "ordinary taxes" or "extraordinary taxes". Normally, it might be considered justifiable to include extraordinary taxes in a Model Convention, but experience has shown that such taxes are generally imposed in very special circumstances. In addition, it would be difficult to define them. They may be extraordinary for various reasons; their imposition, the manner in which they are levied, their rates, their objects, etc. This being so, it seems preferable not to include extraordinary taxes in the Article. But, as it is not intended to exclude extraordinary taxes from all conventions, ordinary taxes have not been mentioned either. The Contracting States are thus free to restrict the convention's field of application to ordinary taxes, to extend it to extraordinary taxes, or even to establish special provisions.

Paragraph 3

6. This paragraph lists the taxes in force at the time of signature of the convention. The list is not exhaustive. It serves to illustrate the preceding paragraphs of the Article. In principle, however, it will be a complete list of taxes imposed in each State at the time of signature and covered by the convention.

Paragraph 4

7. This paragraph provides, since the list of taxes in paragraph 3 is purely declaratory, that the Convention is also to apply to all identifical or substantially similar taxes which are imposed after the date of signature of the Convention in addition to, or in place of, the existing taxes. This provision is necessary to prevent the

Convention from becoming inoperative in the event of one of the States modifying its taxation laws.

8. Each State undertakes to notify the other of any amendments made to its taxation laws by communicating to it at the end of each year, when necessary, a list of new or substituted taxes, imposed during that year.

OBSERVATION ON THE COMMENTARY

9. In contexts such as limitations on the rate of tax or the granting of credits for foreign tax, *New Zealand* would wish to make it clear that the term "tax" does not include penalties.

RESERVATIONS ON THE ARTICLE

10. *Australia, Canada* and the *United States* reserve their positions on that part of paragraph 1 which states that the Convention should apply to taxes of political subdivisions or local authorities.

11. *Japan* reserves its position on that part of paragraph 1 which states that the Convention shall apply to taxes on capital.

* * *

[p. 59] COMMENTARY ON ARTICLE 5 CONCERNING THE DEFINITION OF PERMANENT ESTABLISHMENT

1. The main use of the concept of a permanent establishment is to determine the right of a Contracting State to tax the profits of an enterprise of the other Contracting State. Under Article 7 a Contracting State cannot tax the profits of an enterprise of the other Contracting State unless it carries on its business through a permanent establishment situated therein.

Paragraph 1

2. Paragraph 1 gives a general definition of the term "permanent establishment" which brings out its essential characteristics of a permanent establishment in the sense of the Convention, i.e.,

a distinct "situs", a "fixed place of business". The paragraph defines the term "permanent establishment" as a fixed place of business, through which the business of an enterprise is wholly or partly carried on. This definition, therefore, contains the following conditions:

— the existence of a "place of business", i.e. a facility such as premises or, in certain instances, machinery or equipment;

— this place of business must be "fixed", i.e. it must be established at a distinct place with a certain degree of permanence;

— the carrying on of the business of the enterprise through this fixed place of business. This means usually that persons who, in one way or another, are dependent on the enterprise (personnel) conduct the business of the enterprise in the State in which the fixed place is situated.

3. It could perhaps be argued that in the general definition some mention should also be made of the other characteristic of a permanent establishment to which some importance has sometimes been attached in the past, namely that the establishment must have a productive character — i.e. contribute to the profits of the enterprise. In the present definition this course has not been taken. Within the framework of a well-run business organisation it is surely axiomatic to assume that each part contributes to the productivity of the whole. It does not, of course, follow in every case that because in the wider context of the whole organisation a particular establishment has a "productive character" it is consequently a permanent establishment to which profits can properly be attributed for the purpose of tax in a particular territory (cf. Commentary on paragraph 4).

4. The term "place of business" covers any premises, facilities or installations used for carrying on the business of the enterprise whether or not they are used exclusively for that purpose. A place of business may also exist where no premises are available or required for carrying on the business of the enterprise and it simply has a certain amount of space at its disposal. It is immaterial whether the premises, facilities or installations are

owned or rented by or are otherwise at the disposal of the enterprise. A place of business may thus be constituted [p. 60] by a pitch in a market place, or by a certain permanently used area in a Customs depot (e.g., for the storage of dutiable goods). Again the place of business may be situated in the business facilities of another enterprise. This may be the case, for instance where the foreign enterprise has at its constant disposal certain premises or a part thereof owned by the other enterprise.

5. According to the definition, the place of business has to be a "fixed" one. Thus in the normal way there has to be a link between the place of business and a specific geographical point. It is immaterial how long an enterprise of a Contracting State operates in the other Contracting State if it does not do so at a distinct place, but this does not mean that the equipment constituting the place of business has to be actually fixed to the soil on which it stands. It is enough that the equipment remains on a particular site (but cf. paragraph 19 below):

6. Since the place of business must be fixed, it also follows that a permanent establishment can be deemed to exist only if the place of business has a certain degree of permanency, i.e., if it is not a purely temporary nature. If the place of business was not set up merely for a temporary purpose, it can constitute a permanent establishment, even though it existed, in practice, only for a very short period of time because of the special nature of the activity of the enterprise or because, as a consequence of special circumstances (e.g. death of the taxpayear, investment failure), it was prematurely liquidated. Where a place of business which was, at the outset, designed for a short temporary purpose only, is maintained for such a period that it cannot be considered as a temporary one, it becomes a fixed place of business and thus — retrospectively — a permanent establishment.

7. For a place of business to constitute a permanent establishment the enterprise using it must carry on its business wholly or partly through it. As stated in paragraph 3 above, the activity need not be of a productive character. Furthermore, the activity need not be permanent in the sense that there is no interruption of operation, but operations must be carried out on a regular basis.

8. Where tangible property such as facilities, equipment, buildings, or intangible property such as patents, procedures and similar property, are let or leased to third parties through a fixed place of business maintained by an enterprise of a Contracting State in the other State, this activity will, in general, render the place of business a permanent establishment. The same applies if capital is made available through a fixed place of business. If an enterprise of a State lets or leases facilities, equipment, buildings or intangible property to an enterprise of the other State without maintaining for such letting or leasing activity a fixed place of business in the other State, the leased facility, equipment, building or intangible property, as such, will not constitute a permanent establishment of the lessor provided the contract is limited to the mere leasing of the equipment, etc. This remains the case even when, for example, the lessor supplies personnel after installation to operate the equipment provided that their responsibility is limited solely to the operation or maintenance of the equipment under the direction, responsibility and control of the lessee. If the personnel have wider responsibilities, for example, participation in the decisions regarding the work for which the equipment is used, the activity of the lessor may go beyond the mere leasing of equipment and may constitute an enterpreneurial activity. In such a case a permanent establishment could be deemed to exist if the criterion of permanency is met. When such activity is connected with, or is similar in character to, those mentioned in paragraph 3, the time limit of twelve months applies. Other cases have to be determined according to the circumstances.

[p. 61] 9. The business of an enterprise is carried on mainly by the entrepreneur or persons who are in a paid-employment relationship with the enterprise (personnel). This personnel includes employees and other persons receiving instructions from the enterprise (e.g. dependent agents). The powers of such personnel in its relationship with third parties are irrelevant. It makes no difference whether or not the dependent agent is authorised to conclude contracts if he works at the fixed place of business (cf. paragraph 34 below). But a permanent establishment may nevertheless exist if the business of the enterprise is carried on mainly through automatic equipment, the activities of the personnel being restricted to setting up, operating, controlling

and maintaining such equipment. Whether or not gaming and vending machines and the like set up by an enterprise of a State in the other State constitute a permanent establishment thus depends on whether or not the enterprise carries on a business activity besides the initial setting up of the machines. A permanent establishment does not exist if the enterprise merely sets up the machines and then leases the machines to other enterprises. A permanent establishment may exist, however, if the enterprise which sets up the machines also operates and maintains them for its own account. This also applies if the machines are operated and maintained by an agent dependent on the enterprise.

10. A permanent establishment begins to exist as soon as the enterprise commences to carry on its business through a fixed place of business. This is the case once the enterprise prepares, at the place of business, the activity for which the place of business is to serve permanently. The period of time during which the fixed place of business itself is being set up by the enterprise should not be counted, provided that this activity differs substantially from the activity for which the place of business is to serve permanently. The permanent establishment ceases to exist with the disposal of the fixed place of business or with the cessation of any activity through it, that is when all acts and measures connected with the former activities of the permanent establishment are terminated (winding up current business transactions, maintenance and repair of facilities). A temporary interruption of operations, however, cannot be regarded as a closure. If the fixed place of business is leased to another enterprise, it will normally only serve the activities of that enterprise instead of the lessor's; in general, the lessor's permanent establishment ceases to exist, except where he continues carrying on a business activity of his own through the fixed place of business.

Paragraph 2

11. This paragraph contains a list, by no means exhaustive, of examples, each of which can be regarded, prima facie, as constituting a permanent establishment. As these examples are to be seen against the background of the general definition given in paragraph 1, it is assumed that the Contracting States interpret

the terms listed, "a place of management", "a branch", "an office", etc. in such a way that such places of business constitute permanent establishments only if they meet the requirements of paragraph 1.

12. The term "place of management" has been mentioned separately because it is not necessarily an "office". However, where the laws of the two Contracting States do not contain the concept of a "place of management" as distinct from an "office", there will be no need to refer to the former term in their bilateral convention.

13. Sub-paragraph f) provides that mines, oil or gas wells, quarries or any other place of extraction of natural resources are permanent establishments. The [p. 62] term "any other place of extraction of natural resources" should be interpreted broadly. It includes, for example, all places of extraction of hydrocarbons whether on or off-shore.

14. Sub-paragraph f) refers to the extraction of natural resources, but does not mention the exploration of such resources, whether on or off-shore. Therefore, whenever income from such activities is considered to be business profits, the question whether these activities are carried on through a permanent establishment is governed by paragraph 1. Since, however, it has not been possible to arrive at a common view on the basic questions of the attribution of taxation rights and of the qualification of the income from exploration activities, the Contracting States may agree upon the insertion of specific provisions. They may agree, for instance, that an enterprise of a Contracting State, as regards its activities of exploration of natural resources in a place or area in the other Contracting State:

a) shall be deemed not to have a permanent establishment in that other State; or

b) shall be deemed to carry on such activities through a permanent establishment in that other State; or

c) shall be deemed to carry on such activities through a permanent establishment in that other State if such activities last longer than a specified period of time.

The Contracting States may moreover agree to submit the income from such activities to any other rule.

Paragraph 3

15. This paragraph provides expressly that a building site or construction or installation project constitutes a permanent establishment only if it lasts more than twelve months. Any of those items which does not meet this condition does not of itself constitute a permanent establishment, even if there is within it an installation, for instance an office or a workshop within the meaning of paragraph 2, associated with the construction activity.

16. The term "building site or construction or installation project" includes not only the construction of buildings but also the construction of roads, bridges or canals, the laying of pipe-lines and excavating and dredging. Planning and supervision of the erection of a building are covered by this term, if carried out by the building contractor. However, planning and supervision is not included if carried out by another enterprise whose activities in connection with the construction concerned are restricted to planning and supervising the work. If that other enterprise has an office which it uses only for planning or supervision activities relating to a site or project which does not constitute a permanent establishment, such office does not constitute a fixed place of business within the meaning of paragraph 1, because its existence has not a certain degree of permanence.

17. The twelve month test applies to each individual site or project. In determining how long the site or project has existed, no account should be taken of the time previously spent by the contractor concerned on other sites or projects which are totally unconnected with it. A building site should be regarded as a single unit, even if it is based on several contracts, provided that it forms a coherent whole commercially and geographically. Subject to this proviso, a [p. 63] building site forms a single unit even if the orders have been placed by several persons (e.g. for a row of houses).

18. A site exists from the date on which the contractor begins his work, including any preparatory work, in the country where

the construction is to be established, e.g. if he installs a planning office for the construction. In general, it continues to exist until the work is completed or permanently abandoned. A site should not be regarded as ceasing to exist when work is temporarily discontinued. Seasonal or other temporary interruptions should be included in determining the life of a site. Seasonal interruptions include interruptions due to bad weather. Temporary interruption could be caused, for example, by shortage of material or labour difficulties. Thus, for example, if a contractor started work on a road on 1st May, stopped on 1st November because of bad weather conditions or a lack of materials but resumed work in 1st February the following year, completing the road on 1st June, his construction project should be regarded as a permanent establishment because thirteen months elapsed between the date he first commenced work (1st May) and the date he finally finished (1st June of the following year). If an enterprise (general contractor) which has undertaken the performance of a comprehensive project sub-contracts parts of such a project to other enterprises (sub-contractors), the period spent by a sub-contractor working on the building site must be considered as being time spent by the general contractor on the building project. The sub-contractor himself has a permanent establishment at the site if his activities there last more than twelve months.

19. The very nature of a construction or installation project may be such that the contractor's activity has to be relocated continuously or at least from time to time, as the project progresses. This would be the case for instance where roads or canals were being constructed, waterways dredged, or pipe-lines laid. In such a case, the fact that the work force is not present for twelve months in one particular place is immaterial. The activities performed at each particular spot are part of a single project, and that project must be regarded as a permanent establishment if, as a whole, it lasts more than twelve months.

Paragraph 4

20. This paragraph lists a number of business activities which are treated as exceptions to the general definition laid down in paragraph 1 and which are not permanent establishments, even if

the activity is carried on through a fixed place of business. The common feature of these activities is that they are, in general, preparatory or auxiliary activities. This is laid down explicitly in the case of the exception mentioned in sub-paragraph *e*), which actually amounts to a general restriction of the scope of the definition contained in paragraph 1. Moreover sub-paragraph *f*) provides that combinations of activities mentioned in sub-paragraphs *a*) to *e*) in the same fixed place of business shall be deemed not to be a permanent establishment, provided that the overall activity of the fixed place of business resulting from this combination is of a preparatory or auxiliary character. Thus the provisions of paragraph 4 are designed to prevent an enterprise of one State from being taxed in the other State, if it carries on in that other State, activities of a purely preparatory or auxiliary character.

21. Sub-paragraph *a*) relates only to the case in which an enterprise acquires the use of facilities for storing, displaying or delivering its own goods or merchandise. Sub-paragraph *b*) relates to the stock of merchandise itself and provides that the stock, as such, shall not be treated as a permanent establishment if it is [p. 64] maintained for the purpose of storage, display or delivery. Sub-paragraph *c*) covers the case in which a stock of goods or merchandise belonging to one enterprise is processed by a second enterprise, on behalf of, or for the account of, the first-mentioned enterprise. The reference to the collection of information in sub-paragraph *d*) is intended to include the case of the newspaper bureau which has no purpose oher than to act as one of many "tentacles" of the parent body; to exempt such a bureau is to do no more than to extend the concept of "mere purchase".

22. Sub-paragraph *e*) provides that a fixed place of business through which the enterprise exercises solely an activity which has for the enterprise a preparatory or auxiliary character, is deemed not to be a permanent establishment. The wording of this sub-paragraph makes it unnecessary to produce an exhaustive list of exceptions. Furthermore, this sub-paragraph provides a generalised exception to the general definition in paragraph 1 and, when read with that paragraph, provides a more selective test, by which to determine what constitutes a permanent establishment.

To a considerable degree it limits that definition and excludes from its rather wide scope a number of forms of business organisations which, although they are carried on through a fixed place of business, should not be treated as permanent establishments. It is recognised that such a place of business may well contribute to the productivity of the enterprise, but the services it performs are so remote from the actual realisation of profits that it is difficult to allocate any profit to the fixed place of business in question. Examples are fixed places of business solely for the purpose of advertising or for the supply of information or for scientific research or for the servicing of a patent or a know-how contract, if such activities have a preparatory or auxiliary character.

23. It is often difficult to distinguish between activities which have a preparatory or auxiliary character and those which have not. The decisive criterion is whether or not the activity of the fixed place of business in itself forms an essential and signifciant part of the activity of the enterprise as a whole. Each individual case will have to be examined on its own merits. In any case, a fixed place of business whose general purpose is one which is identical to the general purpose of the whole enterprise, does not exercise a preparatory or auxiliary activity. Where, for example, the servicing of patents and know-how is the purpose of an enterprise, a fixed place of business of such enterprise exercising such an activity cannot get the benefits of sub-paragraph *e*). A fixed place of business which has the function of managing an enterprise or even only a part of an enterprise or of a group of the concern cannot be regarded as doing a preparatory or auxiliary activity, for such a managerial activity exceeds this level. If enterprises with international ramifications establish a so-called "management office" in States in which they maintain subsidiaries, permanent establishments, agents or licensees, such office having supervisory and co-ordinating functions for all departments of the enterprise located within the region concerned, a permanent establishment will normally be deemed to exist, because the management office may be regarded as an office within the meaning of paragraph 2. Where a big international concern has delegated all management functions to its regional management offices so that the functions of the head office of the concern

are restricted to general supervision (so-called polycentric enterprises), the regional management offices even have to be regarded as a "place of management" within the meaning of sub-paragraph *a*) of paragraph 2. The function of managing an enterprise, even if it only covers a certain area of the operations of the concern, constitutes an essential part of the business operations of the enterprise and therefore can [p. 65] in no way be regarded as an activity which has a preparatory or auxiliary character within the meaning of sub-paragraph *e*) of paragraph 4.

24. A permanent establishment could also be constituted if an enterprise maintains a fixed place of business in order to supply spare parts to customers for the machinery supplied to such customers, and to maintain and repair such machinery as this goes beyond the pure delivery mentioned in sub-paragraph *a*) of paragraph 4. Since these after-sale organisations perform an essential and significant part of the services of an enterprise vis-à-vis its customers, their activities are not merely auxiliary ones. Sub-paragraph *e*) applies only if the activity of the fixed place of business is limited to a preparatory or auxiliary one. This would not be the case where, for example, the fixed place of business does not only give information but also furnishes plans etc. specially developed for the purposes of the individual customer. Nor would it be the case if a research establishment were to concern itself with manufacture.

25. Moreover, sub-paragraph *e*) makes it clear that the activities of the fixed place of business must be carried on for the enterprise. A fixed place of business which renders services not only to its enterprise but also directly to other enterprises, for example to other companies of a group to which the company owning the fixed place belongs, would not fall within the scope of sub-paragraph *e*).

26. As already mentioned in paragraph 20 above, paragraph 4 is designed to provide for exceptions to the general definition of paragraph 1 in respect of fixed places of business which are engaged in activities having a preparatory or auxiliary character. Therefore, according to sub-paragraph *f*) of paragraph 4, the fact that one fixed place of business combines any of the activities mentioned in the sub-paragraphs *a*) to *e*) of paragraph 4 does not

mean of itself that a permanent establishment exists. As long as the combined activity of such a fixed place of business is merely preparatory or auxiliary a permanent establishment should be deemed not to exist. Such combinations should not be viewed on rigid lines, but should be considered in the light of the particular circumstances. The criterion "preparatory or auxiliary character" is to be interpreted in the same way as is set out for the same criterion of sub-paragraph *e*) (cf. paragraphs 23 and 24 above). Sub-paragraph *f*) is of no importance in a case where an enterprise maintains several fixed places of business within the meaning of the sub-paragraphs *a*) to *e*) provided that they are separated from each other locally and organisationally, as in such a case each place of business has to be viewed separately and in isolation for deciding the question whether or not a permanent establishment exists. States which want to allow any combination of the items mentioned in sub-paragraphs *a*) to *e*), disregarding whether or not the criterion of the preparatory or auxiliary charater of such a combination is met, are free to do so by deleting the words "provided" to "character" in sub-paragraph *f*).

27. The fixed places of business mentioned in paragraph 4 cannot be deemed to constitute permanent establishments so long as their activities are restricted to the functions which are the prerequisite for assuming that the fixed place of business is not a permanent establishment. This will be the case even if the contracts necessary for establishing and carrying on the business are concluded by those in charge of the places of business themselves. The employees of places of business within the meaning of paragraph 4 who are authorised to conclude such contracts should not be regarded as agents within the meaning of paragraph 5. A case in point would be a research institution the manager of which is authorised to conclude [p. 66] the contracts necessary for maintaining the institution and who exercises this authority within the framework of the functions of the institution. A permanent establishment, however, exists if the fixed place of business exercising any of the functions listed in paragraph 4 were to exercise them not only on behalf of the enterprise to which it belongs but also on behalf of other enterprises. If, for instance, an advertising agency maintained by an enterprise were also to engage in advertising for other enterprises, it would be regarded as

a permanent establishment of the enterprise by which it is maintained.

28. If a fixed place of business under paragraph 4 is deemed not to be a permanent establishment, this exception applies likewise to the disposal of movable property forming part of the business property of the place of business at the termination of the enterprise's activity in such installation (cf. paragraph 10 above and paragraph 2 of Article 13). Since, for example, the display of merchandise is excepted under sub-paragraphs *a*) and *b*), the sale of the merchandise at the termination of a trade fair or convention is covered by this exception. The exception does not, of course, apply to sales of merchandise not actually displayed at the trade fair or convention.

29. A fixed place of business used both for activities which rank as exceptions (paragraph 4) and for other activities would be regarded as a single permanent establishment and taxable as regards both types of activities. This would be the case, for instance, where a store maintained for the delivery of goods also engaged in sales.

Paragraph 5

30. It is a generally accepted principle that an enterprise should be treated as having a permanent establishment in a State if there is under certain conditions a person acting for it, even though the enterprise may not have a fixed place of business in that State within the meaning of paragraphs 1 and 2. This provision intends to give that State the right to tax in such cases. Thus paragraph 5 stipulates the conditions under which an enterprise is deemed to have a permanent establishment in respect of any activity of a person acting for it. The paragraph has been redrafted to clarify the intention of the corresponding provision of the 1963 Draft Convention without altering its substance apart from an extension of the excepted activities of the person.

31. Persons whose activities may create a permanent establishment for the enterprise are so-called dependent agents i.e. persons, whether employees or not, who are not independent

agents falling under paragraph 6. Such persons may be either individuals or companies. It would not have been in the interest of international economic relations to provide that the maintenance of any dependent person would lead to a permanent establishment for the enterprise. Such treatment is to be limited to persons who in view of the scope of their authority or the nature of their activity involve the enterprise to a particular extent in business activities in the State concerned. Therefore, paragraph 5 proceeds on the basis that only persons having the authority to conclude contracts can lead to a permanent establishment for the enterprise maintaining them. In such a case the person has sufficient authority to bind the enterprise's participation in the business activity in the State concerned. The use of the term "permanent establishment" in this context presupposes, of course, that that person makes use of this authority repeatedly and not merely in isolated cases.

[p. 67] 32. The authority to conclude contracts must cover contracts relating to operations which constitute the business proper of the enterprise. It would be irrelevant, for instance, if the person had authority to engage employees for the enterprise to assist that person's activity for the enterprise or if the person were authorised to conclude, in the name of the enterprise, similar contracts relating to internal operations only. Moreover the authority has to be habitually exercised in the other State; whether or not this is the case should be determined on the basis of the commercial realities of the situation. A person who is authorized to negotiate all elements and details of a contract in a way binding on the enterprise can be said to exercise this authority "in that State", even if the contract is signed by another person in the State in which the enterprise is situated. Since, by virtue of paragraph 4, the maintenance of a fixed place of business solely for purposes listed in that paragraph is deemed not to constitute a permanent establishment, a person whose activities are restricted to such purposes does not create a permanent establishment either.

33. Where the requirements set out in paragraph 5 are met, a permanent establishment of the enterprise exists to the extent that the person acts for the latter, i.e. not only to the extent that such a

person exercises the authority to conclude contracts in the name of the enterprise.

34. Under paragraph 5, only those persons who meet the specific conditions, may create a permanent establishment; all other persons are excluded. It should be borne in mind, however, that paragraph 5 simply provides an alternative test of whether an enterprise has a permanent establishment in a State. If it can be shown that the enterprise has a permanent establishment within the meaning of paragraphs 1 and 2 (subject to the provisions of paragraph 4), it is not necessary to show that the person in charge is one who would fall under paragraph 5.

Paragraph 6

35. Where an enterprise of a Contracting State carries on business dealings through a broker, general commission agent or any other agent of an independent status, it cannot be taxed in the other Contracting State in respect of those dealings if the agent is acting in the ordinary course of his business (cf. paragraph 31 above). Although it stands to reason that such an agent, representing a separate enterprise, cannot constitute a permanent establishment of the foreign enterprise, paragraph 6 has been inserted in the Article for the sake of clarity and emphasis.

36. A person will come within the scope of paragraph 6 — i.e. he will not constitute a permanent establishment of the enterprise on whose behalf he acts — only if

a) he is independent of the enterprise both legally and economically, and

b) he acts in the ordinary course of this business when acting on behalf of the enterprise.

37. Whether a person is independent of the enterprise represented depends on the extent of the obligations which this person has vis-à-vis the enterprise. Where the person's commercial activities for the enterprise are subject to detailed instructions or to comprehensive control by it, such person cannot be regarded as independent of the enterprise. Another important criterion will be whether the entrepreneurial risk has to be borne by the person or

by the enterprise the person represents. A subsidiary is not to be considered dependent on its parent company solely because of the parent's ownership of the share capital. Persons cannot be [p. 68] said to act in the ordinary course of their own business if, in place of the enterprise, such persons perform activities which, economically, belong to the sphere of the enterprise rather than to that of their own business operations. Where, for example, a commission agent not only sells the goods or merchandise of the enterprise in his own name but also habitually acts, in relation to that enterprise, as a permanent agent having an authority to conclude contracts, he would be deemed in respect of this particular activity to be a permanent establishment, since he is thus acting outside the ordinary course of his own trade or business (namely that of a commission agent), unless his activities are limited to those mentioned at the end of paragraph 5.

38. According to the definition of the term "permanent establishment" an insurance company of one State may be taxed in the other State on its insurance business, if it has a fixed place of business within the meaning of paragraph 1 or if it carries on business through a person within the meaning of paragraph 5. Since agencies of foreign insurance companies sometimes do not meet either of the above requirements, it is conceivable that these companies do large-scale business in a State without being taxed in that State on their profits arising from such business. In order to obviate this possibility, various conventions concluded by OECD Member countries include a provision which stipulates that insurance companies of a State are deemed to have a permanent establishment in the other State if they collect premiums in that other State through an agent established there — other than an agent who already constitutes a permanent establishment by virtue of paragraph 5 — or insure risks situated in that territory through such an agent. The decision as to whether or not a provision along these lines should be included in a convention will depend on the factual and legal situation prevailing in the Contracting States concerned. Frequently, therefore, such a provision will not be contemplated. In view of this fact, it did not seem advisable to insert a provision along these lines in the Model Convention.

Paragraph 7

39. It is generally accepted that the existence of a subsidiary company does not, of itself, constitute that subsidiary company a permanent establishment of its parent company. This follows from the principle that, for the purpose of taxation, such a subsidiary company constitutes an independent legal entity. Even the fact that the trade or business carried on by the subsidiary company is managed by the parent company does not constitute the subsidiary company a permanent establishment of the parent company.

40. However, a subsidiary company will constitute a permanent establishment for its parent company under the same conditions stipulated in paragraph 5 as are valid for any other unrelated company, i.e. if it cannot be regarded as an independent agent in the meaning of paragraph 6, and if it has and habitually exercises an authority to conclude contracts in the name of the parent company. And the effects would be the same as for any other unrelated company to which paragraph 5 applies.

41. The same rules should apply to activities which one subsidiary carries on for any other subsidiary of the same company.

OBSERVATIONS ON THE COMMENTARY

42. Treatment in Irish tax law of non-resident operators in *Ireland* and in the Irish continental shelf area. Profits arising to a person not resident in Ireland [p. 69] from exploration or exploitation activities in Ireland or in the Irish continental shelf area as well as profits from exploration or exploitation rights are treated as the profits of a trade carried on in Ireland through a branch or agency and are, in consequence, taxable in Ireland. This includes non-resident contractors who supply well-drilling, pipe-laying and similar services in Ireland or in the Irish continental shelf area. In addition, capital gains accruing on the disposal of exploration or exploitation rights in Ireland or in the Irish continental shelf area are treated as gains accruing on the disposal of assets situated in Ireland. When negotiating conventions with other Member countries, Ireland would wish subparagraph *f)* of paragraph 2 to be so drafted and interpreted as to reflect the Irish position.

43. *Italy* does not adhere to the interpretation given in paragraph 11 above concerning the list of examples of paragraph 2. In its opinion, these examples can always be regarded as constituting "a priori" permanent establishments.

44. While, subject to its reservations in relation to this Article, *New Zealand*, for the purpose of negotiating conventions with other Member countries, accepts, in general, the principles of this Article, it would wish to be free to negotiate for the addition of specific provisions deeming an enterprise in some particular situations to have a permanent establishment in New Zealand.

RESERVATIONS ON THE ARTICLE

45. *Australia* reserves the right to treat an enterprise as having a permanent establishment in a State if the enterprise carries on designated supervisory activities in that state for more than twelve months, if substantial equipment is used in that State for more than twelve months by, for or under contract with the enterprise in the exploration of natural resources, or if a person acting in that State on behalf of the enterprise — manufactures or processes there goods or merchandise belonging to the enterprise.

46. *Greece, New Zealand, Portugal* and *Turkey* reserve their positions on paragraph 3, and consider that any building site or construction or installation project which lasts more than six months should be regarded as a permanent establishment.

47. *New Zealand* also reserves its position so as to be able to tax an enterprise which carries on supervisory activities for more than six months in connection with a building site or construction or installation project lasting more than six months, and also an enterprise where substantial equipment or machinery is for more than six months being used by, for or under contract with the enterprise.

48. *Spain* reserves its position on paragraph 3 so as to be able to tax an enterprise having a permanent establishment in Spain, even if the site of the construction or installation project does not last for more than twelve months, where the activity of this enterprise in Spain presents a certain degree of permanency within the meaning of paragraphs 1 and 2.

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[p. 72] COMMENTARY ON ARTICLE 7 CONCERNING THE TAXATION OF BUSINESS PROFITS

I. Preliminary remarks

1. This Article is in many respects a continuation of, and a corollary to, Article 5 on the definition of the concept of permanent establishment. The permanent establishment criterion is commonly used in international double taxation conventions to determine whether a particular kind of income shall or shall not be taxed in the country from which it originates but the criterion does not of itself provide a complete solution to the problem of the double taxation of business profits; in order to prevent such double taxation it is necessary to supplement the definition of permanent establishment by adding to it an agreed set of rules of reference to which the profits made by the permanent establishment, or by an enterprise trading with a foreign member of the same group of enterprises, are to be calculated. To put the matter in a slightly different way, when an enterprise of a Contracting State carries on business in the other Contracting State the authorities of that second State have to ask themselves two questions before they levy tax on the profits of the enterprise: the first question is whether the enterprise has a permanent establishment in their country; if the answer is in the affirmative the second question is what, if any, are the profits on which that permanent establishment should pay tax. It is with the rules to be used in determining the answer to this second question that Article 7 is concerned. Rules for ascertaining the profits of an enterprise of a Contracting State which is trading with an enterprise of the other Contracting State when both enterprises are members of the same group of enterprises or are under the same effective control are dealt with in Article 9.

2. It should perhaps be said at this point that neither Article is strikingly novel or particularly detailed. The question of what criteria should be used in attributing profits to a permanent establishment, and of how to allocate profits from transactions between enterprises under common control, has had to be dealt with in a large number of double taxation conventions and it is

fair to say that the solutions adopted have generally conformed to a standard pattern. It is generally recognized that the essential principles on which this standard pattern is based are well founded, and it has been thought sufficient to restate them with some slight amendments and modifications primarily aimed at producing greater clarity. The two Articles incorporate a number of directives. They do not, nor in the nature of things could they be expected to, lay down a series of precise rules for dealing with every kind of problem that may arise when an enterprise of one State makes profits in another. Modern commerce organises itself in an infinite variety of ways, and it would be quite impossible within the fairly narrow limits of an Article in a double taxation convention to specify an exhaustive set of rules for dealing with every kind of problem that may arise. This, however, is a matter of relatively minor importance, if there is agreement on general lines. [p. 73] Special cases may require special consideration, but it should not be difficult to find an appropriate solution if the problem is approached within the framework of satisfactory rules based on agreed principles.

II. Commentary on the Provisions of the Article

Paragraph 1

3. This paragraph is concerned with two questions. First, it restates the generally accepted principle of double taxation conventions that an enterprise of one State shall not be taxed in the other State unless it carries on business in that other State through a permanent establishment situated therein. It is hardly necessary to argue here the merits of this principle. It is perhaps sufficient to say that it has come to be accepted in international fiscal matters that until an enterprise of one State sets up a permanent establishment in another State it should not properly be regarded as participating in the economic life of that other State to such an extent that it comes within the jurisdiction of that other State's taxing rights.

4. The second and more important point is that it is laid down — in the second sentence — that when an enterprise carries on business through a permanent establishment in another State that

State may tax the profits of the enterprise but only so much of them as is attributable to the permanent establishment; in other words that the right to tax does not extend to profits that the enterprise may derive from that State otherwise than through the permanent establishment. This is a question on which there may be differences of view. Some countries have taken the view that when a foreign enterprise has set up a permanent establishment within their territory it has brought itself within their fiscal jurisdiction to such a degree that they can properly tax all profits that the enterprise derives from their territory, whether the profits come from the permanent establishment or from other activities in that territory. But it is thought that it is preferable to adopt the principle contained in the second sentence of paragraph 1, namely that the test that business profits should not be taxed unless there is a permanent establishment is one that should properly be applied not to the enterprise itself but to its profits. To put the matter another way, the principle laid down in the second sentence of paragraph 1 is based on the view that in taxing the profits that a foreign enterprise derives from a particular country, the fiscal authorities of that country should look at the separate sources of profit that the enterpise derives from their country and should apply to each the permanent establishment test. This is of course without prejudice to other Articles.

5. On this matter, naturally, there is room for differences of view, and since it is an important question it may be useful to set out the arguments for each point of view.

6. Apart from the background question of fiscal jurisdiction, the main argument commonly put forward against the solution advocated above is that there is a risk that it might facilitate avoidance of tax. This solution, the argument runs, might leave it open to an enterprise to set up in a particular country a permanent establishment which made no profits, was never intended to make profits, but existed solely to supervise a trade, perhaps of an extensive nature, that the enterprise carried on in that country through independent agents and the like. Moreover, the argument goes, although the whole of this trade might be directed [p. 74] and arranged by the permanent establishment, it might be difficult in practice to prove that that was the case. If the rates of tax

are higher in that country than they are in the country in which the head office is situated, then the enterprise has a strong incentive to see that it pays as little tax as possible in the other territory; the main criticism of the solution advocated above is that it might conceivably provide the enterprise with a means of ensuring that result.

7. Apart again from the question of the proper extent of fiscal jurisdiction, the main argument in favour of the proposed solution is that it is conducive to simple and efficient administration, and that it is more closely adapted to the way in which business is commonly transacted. The organisation of modern business is highly complex. In OECD Member countries, there are a considerable number of companies each of which is engaged in a wide diversity of activities and is carrying on business extensively in many countries. It may be that such a company may have set up a permanent establishment in a second country and may be transacting a considerable amount of business through that permanent establishment in one particular kind of manufacture; that a different part of the same company may be selling quite different goods or manufactures in that second country through independent agents; and that the company may have perfectly genuine reasons for taking this course — reasons based, for example, either on the historical pattern of its business or on commercial convenience. Is it desirable that the fiscal authorities should go so far as to insist on trying to search out the profit element of each of the transactions carried on through independent agents, with a view to aggregating that profit with the profits of the permanent establishment? Such an Article might interfere seriously with ordinary commercial processes, and so be out of keeping with the aims of the Convention.

8. It is no doubt true that evasion of tax could be practised by undisclosed channelling of profits away from a permanent establishment and that this may sometimes need to be watched, but it is necessary in considering this point to preserve a sense of proportion and to bear in mind what is said above. It is not, of course, sought in any way to sanction any such malpractice, or to shelter any concern thus evading tax from the consequences that would follow from detection by the fiscal authorities concerned. It

is fully recognised that Contracting States should be free to use all methods at their disposal to fight fiscal evasion.

9. For the reasons given above, it is thought that the argument that the solution advocated might lead to increased avoidance of tax by foreign enterprises should not be given undue weight. Much more importance is attached to the desirability of interfering as little as possible with existing business organisation and of refraining from inflicting demands for information on foreign enterprises which are unnecessarily onerous.

Paragraph 2

10. This paragraph contains the central directive on which the allocation of profits to a permanent establishment is intended to be based. The paragraph incorporates the view, which is generally contained in bilateral conventions, that the profits to be attributed to a permanent establishment are those which that permanent establishment would have made if, instead of dealing with its head office, it had been dealing with an entirely separate enterprise under conditions and at prices prevailing in the ordinary market. Normally, these would be the same profits that one would expect to be determined by the ordinary processes [p. 75] of good business accountancy. This principle also extends to the allocation of profits which the permanent establishment may derive from transactions with other permanent establishments of the enterprise and with associated companies and their permanent establishments; but Contracting States which consider that the existing paragraph does not in fact cover these more general transactions may, in their bilateral negotiations, agree upon more detailed provisions.

11. In the great majority of cases, trading accounts of the permanent establishment — which are commonly available if only because a well-run business organisation is normally concerned to know what is the profitability of its various branches — will be used by the taxation authorities concerned to ascertain the profit properly attributable to that establishment. Exceptionally there may be no separate accounts (cf. paragraphs 23 to 27 below). But where there are such accounts they will naturally form the starting point for any processes of adjustment in case

adjustment is required to produce the amount of properly attributable profits. It should perhaps be emphasized that the directive contained in paragraph 2 is no justification for tax administrations to construct hypothetical profit figures in vacuo; it is always necessary to start with the real facts of the situation as they appear from the business records of the permanent establishment and to adjust as may be shown to be necessary the profit figures which those facts produce. It should also be noted that the principle set out in paragraph 2 is subject to the provisions contained in paragraph 3, especially as regards the treatment of payments which, under the name of interest, royalties, etc. are made by a permanent establishment to its head office in return for money loaned, or patent rights conceded by the latter to the permanent establishment (cf. paragraphs 16 below and following).

12. Even where a permanent establishment is able to produce proper accounts which purport to show the profits arising from its activities, it may still be necessary for the taxation authorities of the country concerned to rectify those accounts, in accordance with the general directive laid down in paragraph 2. Adjustment of this kind may be necessary, for example, because goods have been invoiced from the head office to the permanent establishment at prices which are not consistent with this directive, and profits have thus been diverted from the permanent establishment to the head office, or vice versa.

13. In such cases, it will usually be appropriate to substitute for the prices used ordinary market prices for the same or similar goods supplied on the same or similar conditions. Clearly the price at which goods can be bought on open market terms varies with the quantity required and the period over which they will be supplied; such factors would have to be taken into account in deciding the open market price to be used. It is perhaps only necessary to mention at this point that there may sometimes be perfectly good commercial reasons for an enterprise invoicing its goods at prices less than those prevailing in the ordinary market; this may, for example, be a perfectly normal commercial method of establishing a competitive position in a new market and should not then be taken as evidence of an attempt to divert profits from

one country to another. Difficulties may also occur in the case of proprietary goods produced by an enterprise, all of which are sold through its permanent establishments; if in such circumstances there is no open market price, and it is thought that the figures in the accounts are unsatisfactory, it may be necessary to calculate the permanent establishment's profits by other methods, for example, by applying an average ratio of gross profit to the turnover of the permanent establishment and then deducting [p. 76] from the figure so obtained the proper amount of expenses incurred. Clearly many special problems of this kind may arise in individual cases but the general rule should always be that the profits attributed to a permanent establishment should be based on that establishment's accounts insofar as accounts are available which represent the real facts of the situation. If available accounts do not represent the real facts then new accounts will have to be constructed, or the original ones rewritten, and for this purpose the figures to be used will be those prevailing in the open market.

14. Some States consider that there is a realisation of a taxable profit when an asset, other then trading stock, forming part of the business property of a permanent establishment situated within their territory is transferred to a permanent establishment or the head office of the same enterprise situated in another State. Article 7 allows such States to tax profits deemed to arise in connection with such a transfer. Such profits may be determined as indicated in paragraphs 10 to 13 above.

Paragraph 3

15. This paragraph clarifies, in relation to the expenses of a permanent establishment, the general directive laid down in paragraph 2. The paragraph specifically recognises that in calculating the profits of a permanent establishment allowance is to be made for expenses, wherever incurred, that were incurred for the purposes of the permanent establishment. Clearly in some cases it will be necessary to estimate or to calculate by conventional means the amount of expenses to be taken into account. In the case, for example, of general administrative expenses incurred at the head office of the enterprise, it may be appropriate to take into

account a proportionate part based on the ratio that the permanent establishment's turnover (or perhaps gross profits) bears to that of the enterprise as a whole. Subject to this, it is considered that the amount of expenses to be taken into account as incurred for the purposes of the permanent establishment should be the actual amount so incurred. The deduction allowable to the permanent establishment for any of the expenses of the enterprise attributed to it does not depend upon the actual reimbursement of such expenses by the permanent establishment.

16. Apart from what may be regarded as ordinary expenses, there are some classes of payments between permanent establishments and head offices which give rise to special problems, and it is convenient to deal with them at this point. The next paragraphs discuss three specific cases of this kind and give solutions for them. It should not, of course, be inferred that it is only in relation to the three classes of payments mentioned in these paragraphs that problems may arise; there may well be payments of other kinds to which similar considerations apply.

17. The first of these cases relates to payments which under the name of interest, royalties, etc. are made by a permanent establishment to its head office in return for money loaned, or patent rights conceded, by the latter to the permanent establishment. In such a case, it is considered that the payments should not be allowed as deductions in computing the permanent establishment's taxable profits. Equally, such payments made to a permanent establishment by the head office should be excluded from the computation of the permanent establishment's taxable profits. It is, however, recognised that special considerations apply to payments of interest made by different parts of a financial enterprise (e.g. a bank) to each other on advances etc. (as distinct from capital allotted to them), in view [p. 77] of the fact that making and receiving advances is narrowly related to the ordinary business of such enterprises. Furthermore, if an enterprise makes payments of interest, etc. to a third party and these payments in part relate to the activities of the permanent establishment, then a proportionate part of them should naturally be taken into account in calculating the permanent establishment's

profits insofar as they can properly be regarded as expenses incurred for the purposes of the permanent establishment.

18. The second case relates to the performance of ancillary services by a permanent establishment on behalf of its head office or vice versa. Consider, for example, the case of a large company with a varied business, part of which it carries on in another country through a permanent establishment. In addition, that permanent establishment advertises on behalf of its head office goods which that enterprise produces but which the permanent establishment itself does not handle. Clearly, in calculating for tax purposes the profits of the permanent establishment, the profits should be increased by the amount of the expense it has incurred on behalf of the head office (unless, of course, such an adjustment has already been made in drawing up the accounts of the permanent establishment). In fact if the permanent establishment and its head office were entirely separate and independent, the permanent establishment would ordinarily carry out services for the head office only if it were paid a commission as well as reimbursed the actual expenses incurred. It is, therefore, necessary to decide whether the calculation should be made on the basis of account being taken not only of any expenses borne by a permanent establishment by reason of services performed for the head office but also of a notional commission increasing the profits of the permanent establishment.

19. After consideration of this question, it is thought that in such circumstances the profits of the permanent establishment should not be increased by the addition of a "commission" figure. While, on one view, to include a "commission" figure in the profits of every permanent establishment that has performed services otherwise than for its own purposes could be looked at in theory as a consequential application of the fiction of separate enterprise, it would inevitably be found exceedingly cumbersome in practice. There would be scope for lengthy argument about, and usually no concrete basis for detemining, the percentage to be used in calculating the amount of notional "commission". In the great majority of cases the accounts of the permanent establishment would doubtless take into consideration actual expenses incurred; in other words they would not normally include any

credit for "commission". If as a general rule the "separate enterprise" test were to be applied to services performed by a permanent establishment on behalf of its head office and a notional "commission" profit were to be included in the profits of the permanent establishment, it would, therefore, be necessary in the great majority of cases first to settle how the "commission" element was to be calculated and then re-write the accounts of the permanent establishment. Considerations of practical administration weigh heavily against such a course. Therefore no "commission" element should in such cases be included in the profits of the permanent establishment. Similarly, in the converse case where the head office undertakes services on behalf of the permanent establishment, no "commission" element should be deducted in determining the profits of the permanent establishment.

20. The third case is related to the question whether any part of the total profits of an enterprise should be deemed to arise from the exercise of good [p. 78] management. Consider the case of a company that has its head office in one country but carries on all its business through a permanent establishment situated in another country. In the extreme case it might well be that only the directors' meetings were held at the head office and that all other activities of the company, apart from purely formal legal activities, were carried on in the permanent establishment. In such a case there is something to be said for the view that at least part of the profits of the whole enterprise arose from the skilfull management and business acumen of the directors and that part of the profits of the enterprise ought, therefore, to be attributed to the country in which the head office was situated. If the company has been managed by a managing agency, then that agency would doubtless have charged a fee for its services and the fee might well have been a simple percentage participation in the profits of the enterprise. But, once again, whatever the theoretical merits of such a course, practical considerations weigh heavily against it. In the kind of case quoted the expenses of management would, of course, be set against the profits of the permanent establishment in accordance with the provisions of paragraph 3, but when the matter is looked at as a whole, it is thought that it would not be right to go further by deducting and taking into account some

notional figure for "profits of management". In cases identical to the extreme case mentioned above, no account should therefore be taken in determining taxable profits of the permanent establishment of any notional figure such as profits of management.

21. It may be, of course, that countries where it has been customary to allocate some proportion of the total profits of an enterprise to the head office of the enterprise to represent the profits of good management will wish to continue to make such an allocation. Nothing in the Article is designed to prevent this. Nevertheless it follows from what is said in paragraph 20 above that a country in which a permanent establishment is situated is in no way required to deduct when calculating the profits attributable to that permanent establishment an amount intended to represent a proportionate part of the profits of management attributable to the head office.

22. It might well be that if the country in which the head office of an enterprise is situated allocates to the head office some percentage of the profits of the enterprise only in respect of good management, while the country in which the permanent establishment is situated does not, the resulting total of the amounts charged to tax in the two countries would be greater than it should be. In any such case the country in which the head office of the enterprise is situated should take the initiative in arranging for such adjustments to be made in computing the taxation liability in that country as may be necessary to ensure that any double taxation is eliminated.

23. It is usually found that there are, or there can be constructed, adequate accounts for each part or section of an enterprise so that profits and expenses, adjusted as may be necessary, can be allocated to a particular part of the enterprise with a considerable degree of precision. This method of allocation is, it is thought, to be preferred in general wherever it is reasonably practicable to adopt it. There are, however, circumstances in which this may not be the case and paragraphs 2 and 3 are in no way intended to imply that other methods cannot properly be adopted where appropriate in order to arrive at the profits of a permanent establishment on a "separate enterprise" footing. It may well be, for example, that profits of insurance enterprises can

most conveniently be ascertained by special methods of computation, e.g. by applying appropriate co-efficients to gross premiums received from policy holders in the country concerned. Again, [p. 79] in the case of a relatively small enterprise operating on both sides of the border between two countries, there may be no proper accounts for the permanent establishment nor means of constructing them. There may, too, be other cases where the affairs of the permanent establishment are so closely bound up with those of the head office that it would be impossible to disentangle them on any strict basis of branch accounts. Where it has been customary in such cases to estimate the arm's length profit of a permanent establishment by reference to suitable criteria, it may well be reasonable that that method should continue to be followed, notwithstanding that the estimate thus made may not achieve as high a degree of accurate measurement of the profit as adequate accounts. Even where such a course has not been customary, it may, exceptionally, be necessary for practical reasons to estimate the arm's length profits.

Paragraph 4

24. It has in some cases been the practice to determine the profits to be attributed to a permanent establishment not on the basis of separate accounts or by making an estimate of arm's length, but simply by apportioning the total profits of the enterprise by reference to various formulae. Such a method differs from those envisaged in paragraph 2, since it contemplates not an attribution of profits on a separate enterprise footing, but an apportionment of total profits; and indeed it might produce a result in figures which would differ from that which would be arrived at by a computation based on separate accounts. Paragraph 4 makes it clear that such a method may continue to be employed by a Contracting State if it has been customary in that State to adopt it, even though the figure arrived at may at times differ to some extent from that which would be obtained from separate accounts, provided that the result can fairly be said to be in accordance with the principles contained in the Article. It is emphasized, however, that in general the profits to be attributed to a permanent establishment should be determined by reference to the establishment's accounts if these reflect the real facts. It is

considered that a method of allocation which is based on apportioning total profits is generally not as appropriate as a method which has regard only to the activities of the permanent establishment and should be used only where, exceptionally, it has as a matter of history been customary in the past and is accepted in the country concerned both by the taxation authorities and taxpayers generally there as being satisfactory. It is understood that paragraph 4 may be deleted where neither State uses such a method. Where, however, Contracting States wish to be able to use a method which has not been customary in the past the paragraph should be amended during the bilateral negotiations to make this clear.

25. It would not, it is thought, be appropriate within the framework of this Commentary to attempt to discuss at length the many various methods involving apportionment of total profits that have been adopted in particular fields for allocating profits. These methods have been well documented in treatises on international taxation. It may, however, not be out of place to summarise briefly some of the main types and to lay down some very general directives for their use.

26. The essential character of a method involving apportionment of total profits is that a proportionate part of the profits of the whole enterprise is allocated to a part thereof, all parts of the enterprise being assumed to have contributed on the basis of the criterion or criteria adopted to the profitability of the whole. [p. 80] The difference between one such method and another arises for the most part from the varying criteria used to determine what is the correct proportion of the total profits. It is fair to say that the criteria commonly used can be grouped into three main categories, namely those which are based on the receipts of the enterprise, its expenses or its capital structure. The first category covers allocation methods based on turnover or on commission, the second on wages and the third on the proportion of the total working capital of the enterprise allocated to each branch or part. It is not, of course, possible to say in vacuo that any of these methods is intrinsically more accurate than the others; the appropriateness of any particular method will depend on the circumstances to which it is applied. In some enterprises,

such as those providing services or producing proprietary articles with a high profit margin, net profits will depend very much on turnover. For insurance enterprises it may be appropriate to make an apportionment of total profits by reference to premiums received from policy holders in each of the countries concerned. In the case of an enterprise manufacturing goods with a high cost raw material or labour content, profits may be found to be related more closely to expenses. In the case of banking and financial concerns the proportion of total working capital may be the most relevant criterion. It is considered that the general aim of any method involving apportionment of total profits ought to be to produce figures of taxable profit that approximate as closely as possible to the figures that would have been produced on a separate accounts basis, and that it would not be desirable to attempt in this connection to lay down any specific directive other than that it should be the responsibility of the taxation authority, in consultation with the authorities of other countries concerned, to use the method which in the light of all the known facts seems most likely to produce that result.

27. The use of any method which allocates to a part of an enterprise a proportion of the total profits of the whole does, of course, raise the question of the method to be used in computing the total profits of the enterprise. This may well be a matter which will be treated differently under the laws of different countries. This is not a problem which it would seem practicable to attempt to resolve by laying down any rigid rule. It is scarcely to be expected that it would be accepted that the profits to be apportioned should be the profits as they are computed under the laws of one particular country; each country concerned would have to be given the right to compute the profits according to the provisions of its own laws.

Paragraph 5

28. In paragraph 4 of Article 5 there are listed a number of examples of activities which, even though carried on at a fixed place of business, are deemed not to be included in the term "permanent establishment." In considering rules for the allocation of profits to a permanent establishment the most important of

these examples is the activity mentioned in paragraph 5 of this Article, i.e. the purchasing office.

29. Paragraph 5 is not, of course, concerned with the organisation established solely for purchasing; such an organization is not a permanent establishment and the profits allocation provisions of this Article would not therefore come into play. The paragraph is concerned with a permanent establishment which although carrying on other business also carries on purchasing for its head office. In such a case the paragraph provides that the profits of the permanent establishment shall not be increased by adding to them a notional figure for profits from purchasing. It follows, of course, that any expenses that arise from the purchasing activities [p. 81] will also be excluded in calculating the taxable profits of the permanent establishment.

Paragraph 6

30. This paragraph is intended to lay down clearly that a method of allocation once used should not be changed merely because in a particular year some other method produces more favourable results. One of the purposes of a double taxation convention is to give an enterprise of a Contracting State some degree of certainty about the tax treatment that will be accorded to its permanent establishment in the other Contracting State as well as to the part of it in its home State which is dealing with the permanent establishment; for this reason, paragraph 6 gives an assurance of continuous and consistent tax treatment.

Paragraph 7

31. Although it has not been found necessary in the Convention to define the term "profits," it should nevertheless be understood that the term when used in this Article and elsewhere in the Convention has a broad meaning including all income derived in carrying on an enterprise. Such a broad meaning corresponds to the use of the term made in the tax laws of most OECD Member countries.

32. This interpretation of the term "profits," however, may give rise to some uncertainty as to the application of the Convention. If the profits of an enterprise include categories of income which are treated separately in other Articles of the Convention, e.g. dividends, it may be asked whether the taxation of those profits is governed by the special Article on dividends etc., or by the provisions of this Article.

33. To the extent that an application of this Article and the special Article concerned would result in the same tax treatment, there is little practical significance to this question. Further, it should be noticed that some of the special Articles contain specific provisions giving priority to a specific Article (cf. paragraph 4 of Article 6, paragraph 4 of Articles 10 and 11, paragraph 3 of Article 12, and paragraph 2 of Article 21).

34. It has seemed desirable, however, to lay down a rule of interpretation in order to clarify the field of application of the present Article in relation to the other Articles dealing with a specific category of income. In conformity with the practice generally adhered to in existing bilateral conventions, paragraph 7 gives first preference to the special Articles on dividends, interest etc. It follows from the rule that this Article will be applicable to industrial and commercial income which does not belong to categories of income covered by the special Articles, and, in addition, to dividends, interest etc. which under paragraph 4 of Articles 10 and 11, paragraph 3 of Article 12 and paragraph 2 of Article 21, fall within this Article. It is understood that the items of income covered by the special Articles may, subject to the provisions of the Convention, be taxed either separately, or as industrial and commercial profits, in conformity with the tax laws of the Contracting States.

35. It is open to Contracting States to agree bilaterally upon special explanations or definitions concerning the term "profits" with a view to clarifying the distinction between this term and e.g. the concept of dividends. It may in particular be found appropriate to do so where in a convention under negotiation a deviation has been made from the definitions in the special Articles on dividends, interest [p. 82] and royalties. It may also be deemed desirable if the Contracting States wish to place on notice, that, in agreement with the domestic tax laws of one or both of the States, the term "profits" includes special classes of receipts such as

income from the alienation of the letting of a business or of movable property used in a business. In this connnection it may have to be considered whether it would be useful to include also additional rules for the allocation of such special profits.

Observations on the Commentary

36. *Australia* and *New Zealand* would wish to be free to propose in bilateral negotiations a provision to the effect that, if the information available to the competent authority of a Contracting State is inadequate to determine the profits to be attributed to the permanent establishment of an enterprise, the competent authority may apply to that enterprise for that purpose the provisions of the taxation law of that State, subject to the qualification that such law will be applied, so far as the information available to the competent authority permits, in accordance with the principles of this Article.

37. *Australia* would wish that in this Article there be provision that will permit resort to domestic law in relation to the taxation of the profit of an insurance enterprise.

38. While *New Zealand,* for the purpose of negotiating conventions with other Member countries, accepts, in general, the principles of this Article relating to the attribution of profits to a permanent establishment, it would wish to be free to negotiate for the inclusion of specific provision governing the basis of attribution in some particular situations.

Reservations on the Article

39. *New Zealand* reserves the right to exclude from the scope of this Article income from the business of any form of issuance.

40. The *United States* believes it appropriate to provide in paragraph 2 for arm's length treatment not only with the head office of the enterprise, but also with any person controlling, controlled by, or subject to the same common control as, the enterprise. This can be accomplished by changing the phrase "separate enterprise" to "independent enterprise" and by deleting the last fourteen words.

* * *

[p. 88] COMMENTARY ON ARTICLE 9 CONCERNING THE TAXATION OF ASSOCIATED ENTERPRISES

Paragraph 1

1. This Article deals with associated enterprises (parent and subsidiary companies and companies under common control) and its paragraph 1 provides that in such cases the taxation authorities of a Contracting State may for the purpose of calculating tax liabilities re-write the accounts of the enterprises if as a result of the special relations between the enterprises the accounts do not show the true taxable profits arising in that State. It is evidently appropriate that adjustment should be sanctioned in such circumstances, and this paragraph seems to call for very little comment. It should perhaps be mentioned that the provisions of this paragraph apply only if special conditions have been made or imposed between the two enterprises. No re-writing of the accounts of associated enterprises is authorised if the transactions between such enterprises have taken place on normal open market commercial terms (on an arm's length basis).

Paragraph 2

2. The re-writing of transactions between associated enterprises in the situation envisaged in paragraph 1 may give rise to economic double taxation (taxation of the same income in the hands of different persons), insofar as an enterprise of State A whose profits are revised upwards will be liable to tax on an amount of profit which has already been taxed in the hands of its associated enterprise in State B. Paragraph 2 provides that in these circumstances, State B shall make an appropriate adjustment so as to relieve the double taxation.

3. It should be noted, however, that an adjustment is not automatically to be made in State B simply because the profits in State A have been increased; the adjustment is due only if State B considers that the figure of adjusted profits correctly reflects what the profits would have been if the transactions had been at arm's length. In other words, the paragraph does not seek to avoid a double charge to tax which arises where the profits of one

associated enterprise are increased to a level which exceeds what they would have been if they had been correctly computed on an arm's length basis. State **B** is therefore committed to make an adjustment of the profits of the affiliated company only if it considers that the adjustment made in State A is justified both in principle and as regards the amount.

4. The paragraph does not specify the method by which an adjustment is to be made. OECD Member countries use different methods to provide relief in these circumstances and it is therefore left open for Contracting States to agree bilaterally on any specific rules which they wish to add to the Article. Some States, for example, would prefer the system under which, where the profits of enterprise X in State A are increased to what they would have been on an arm's [p. 89] length basis, the adjustment would be made by re-opening the assessment on the associated enterprise Y in State B containing the doubly taxed profits in order to reduce the taxable profit by an appropriate amount. Some other States, on the other hand, would prefer to provide that, for the purposes of Article 23, the doubly taxed profits should be treated in the hands of enterprise Y of State B as if they may be taxed in State A; accordingly, the enterprise of State B is entitled to relief in State B, under Article 23; in respect of tax paid by its associate enterprise in State A.

5. It is not the purpose of the paragraph to deal with what might be called "secondary adjustments". Suppose that an upward revision of taxable profits of enterprise X in State A has been made in accordance with the principle laid down in paragraph 1; and suppose also that an adjustment is made to the profits of enterprise Y in State B in accordance with the principle laid down in paragraph 2. The position has still not been restored exactly to what it would have been had the transactions taken place at arm's length prices because, as a matter of fact, the money representing the profits which are the subject of the adjustment is found in the hands of enterprise Y instead of in those of enterprise X. It can be argued that if arm's length pricing had operated and enterprise X had subsequently wished to transfer these profits to enterprise Y, it would have done so in the form of, for example, a dividend or a royalty (if enterprise Y were the

parent of enterprise X) or in the form of, for example, a loan (if enterprise X were the parent of enterprise Y); and that in those circumstances there could have been other tax consequences (e.g. the operation of a withholding tax) depending upon the type of income concerned and the provisions of the Article dealing with such income.

6. These secondary adjustments, which would be required to establish the situation exactly as it would have been if transactions had been at arm's length, depend on the facts of the individual case. It should be noted that nothing in paragraph 2 prevents such secondary adjustments from being made where they are permitted under the domestic laws of Contracting States.

7. The paragraph also leaves open the question whether there should be a period of time after the expiration of which State B would not be obliged to make an appropriate adjustment to the profits of enterprise Y following an upward revision of the profits of enterprise X in State A. Some States consider that State B's commitment should be open-ended—in other words, that however many years State A goes back to revise assessments, enterprise Y should in equity be assured of an appropriate adjustment in State B. Other States consider that an open-ended commitment of this sort is unreasonable as a matter of practical administration. In the circumstances, therefore, this problem has not been dealt with in the text of the Article; but Contracting States are left free in bilateral conventions to include, if they wish, provisions dealing with the length of time during which State B is to be under obligation to make an appropriate adjustment.

8. If there is a dispute between the interested parties over the character and amount of the appropriate adjustment, the matter will be dealt with in the same way as any other question of fact; if necessary the competent authorities may consult each other.

Observations of the Commentary

9. In negotiating conventions with other Member countries, *Australia* and *New Zealand* would wish to be free to propose a provision to the effect that, if [p. 90] the information available to the competent authority of a Contracting State is inadequate to

determine the profits to be attributed to an enterprise, the competent authority may apply to that enterprise for that purpose the provisions of the taxation law of that State, subject to the qualification that such law will be applied, as far as the information available to the competent authority permits, in accordance with the principles of this Article.

10. *Australia* would wish that, in this Article, there be provision that will permit resort to domestic law in relation to the taxation of the profits of an insurance enterprise.

Reservations on the Article

11. *Belgium, Finland, Germany, Italy, Japan, Portugal* and *Switzerland* reserve the right not to insert paragraph 2 in their conventions.

12. The *United States* believes that this Article should apply to all related persons, not just an enterprise of one Contracting State and a related enterprise of the other Contracting State, and that it should apply to "income, deductions, credits or allowances," not just to "profits."

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[p. 162] COMMENTARY ON ARTICLE 24 CONCERNING NON-DISCRIMINATION

Paragraph 1

1. This paragraph establishes the principle that for purposes of taxation discrimination on the grounds of nationality is forbidden, and that, subject to reciprocity, the nationals of a Contracting State may not be less favourably treated in the other Contracting State than nationals of the latter State in the same circumstances.

2. It is noteworthy that the principle of non-discrimination, under various descriptions and with a more or less wide scope, was applied in international fiscal relations well before the appearance, at the end of the 19th Century, of the classic type of double taxation conventions. Thus, in a great many agreements of different kinds (consular or establishment conventions, treaties of

friendship or commerce, etc.) concluded by States, especially in the 19th Century, in order to extend and strengthen the diplomatic protection of their nationals wherever resident, there are clauses under which each of the two Contracting States undertakes to accord nationals of the other State equality of treatment with its own nationals. The fact that such clauses subsequently found their way into double taxation conventions has in no way affected their original justification and scope. The text of paragraph 1 provides that the application of this paragraph is not restricted by Article 1 to nationals solely who are residents of a Contracting State, but on the contrary, extends to all nationals of each Contracting State, whether or not they be residents of one of them. In other words, all nationals of a Contracting State are entitled to invoke the benefit of this provision as against the other Contracting State. This holds good, in particular, for nationals of the Contracting States who are not residents of either of them but of a third State.

3. The expression "in the same circumstances" refers to taxpayers (individuals, legal persons, partnerships and associations) placed, from the point of view of the application of the ordinary taxation laws and regulations, in substantially similar circumstances both in law and in fact.

4. Consequently if a Contracting State, in giving relief from taxation on account of family responsibilities, distinguishes between its own nationals according to whether they reside in its territory or not, that State cannot be obliged to give nationals of the other State who do not reside in its territory the same treatment as it gives its resident nationals but it undertakes to exend to them the same treatment as is available to its non-resident nationals.

5. Likewise, the provisions of paragraph 1 are not to be construed as obliging a State which accords special taxation privileges to its own public bodies or services as such, to extend the same privileges to the public bodies and services of the other State.

[p. 163] 6. Neither are they to be construed as obliging a State which accords special taxation privileges to private institu-

tions not for profit whose activities are performed for purposes of public benefit, which are specific to that State, to extend the same privileges to similar institutions whose activities are not for its benefit.

7. To take the first of these two cases, if a State accords immunity from taxation to its own public bodies and services, this is justified because such bodies and services are integral parts of the State and at no time can their circumstances be comparable to those of the pubic bodies and services of the other State. Nevertheless, this reservation is not intended to apply to State corporations carrying on gainful undertakings. To the extent that these can be regarded as being on the same footing as private industrial and commercial undertakings, the provisions of paragraph 1 will apply to them.

8. As for the second case, if a State accords taxation privileges to certain private institutions not for profit, this is clearly justified by the very nature of these institutions' activities and by the benefit which that State and its nationals will derive from those activities.

9. Furthermore, paragraph 1 has been deliberately framed in a negative form. By providing that the nationals of a Contracting State may not be subjected in the other Contracting State to any taxation or any requirement connected therewith which is other or more burdensome than the taxation and connected requirements to which nationals of the other Contracting State in the same circumstances are or may be subjected, this paragraph has the same mandatory force as if it enjoined the Contracting States to accord the same treatment to their respective nationals. But since the principal object of this clause is to forbid discrimination in one State against the nationals of the other, there is nothing to prevent the first State from granting to persons of foreign nationality, for special reasons of its own, or in order to comply with a special stipulation in a double taxation convention, such as, notably, the requirement that profits of permanent establishments are to be taxed on the basis of separate accounts, certain concessions or facilities which are not available to its own nationals. As it is worded, paragraph 1 would not prohibit this.

10. Subject to the foregoing observation, the words "... shall not be subjected ... to any taxation or any requirement connected therewith which is other or more burdensome ..." mean that when a tax is imposed on nationals and foreigners in the same circumstances, it must be in the same form as regards both the basis of charge and the method of assessment, its rate must be the same, and, finally, the formalities connected with the taxation (returns, payment, prescribed times, etc.) must not be more onerous for foreigners than for nationals.

Paragraph 2

11. Paragraph 2 merely stipulates that the term "nationals" applies to all individuals possessing the nationality of a Contracting State. It has not been judged necessary here to introduce into the text of the Article any considerations on the signification of the concept of nationality, any more than it seemed indispensable to make any special comment here on the meaning and application of the word. Obviously, in determining in relation to individuals, what is meant by "the nationals of a Contracting State," reference must be made to the sense in which the term is usually employed and each State's particular rules on the acquisition or loss of nationality.

[p. 164] 12. But paragraph 2 is more specific as to legal persons, partnerships and associations. By declaring that all legal persons, partnerships and associations deriving their status as such from the laws in force in a Contracting State are considered to be nationals for the purposes of paragraph 1, the provision disposes of a difficulty which often arises in determining the nationality of companies. In defining the nationality of companies, certain States have regard less to the law which governs the company than to the origin of the capital with which the company was formed or the nationality of the individuals or legal persons controlling it.

13. Moreover, in view of the legal relationship created between the company and the State under whose law it is constituted, which from certain points of view is closely akin to the relationship of nationality in the case of individuals, it seems justifiable not to deal with legal persons, partnerships and associa-

tions in a special provision, but to assimilate them with individuals under the term "nationals".

Paragraph 3

14. On 28th September, 1954, a number of States concluded in New York a Convention relating to the status of stateless persons, under Article 29 of which stateless persons must be accorded national treatment. The signatories of the Convention include several OECD Member countries.

15. It should, however, be recognised that the provisions of paragraph 3 will, in a bilateral convention, enable national treatment to be extended to stateless persons who, because they are in one of the situations enumerated in paragraph 2 of Article 1 of the above-mentioned Convention of 28th September, 1954, are not covered by that Convention. This is mainly the case, on the one hand, of persons receiving at the time of signature of that Convention, protection or assistance from organs or agencies of the United Nations other than the United Nations High Commissioner for Refugees, and, on the other hand, of persons who are residents of a country and who there enjoy and are subject to the rights and obligations attaching to the possession of that country's nationality.

16. The purpose of paragraph 3 is to limit the scope of the clause concerning equality of treatment with nationals of a Contracting State solely to stateless persons who are residents of that of the other Contracting State.

17. By thus excluding stateless persons who are residents of neither Contracting State, such a clause prevents their being privileged in one State as compared with nationals of the other State.

18. However, if States were to consider it desirable in their bilateral relations, to extend the application of paragraph 3 to all stateless persons, whether residents of a Contracting State or not, so that in all cases they enjoy the most favourable treatment accorded to nationals of the State concerned, in order to do this they would need only to adopt the following text which contains no condition as to residence in a Contracting State:

"Notwithstanding the provisions of Article 1, stateless persons shall not be subjected in a Contracting State to any taxation or any requirement connected therewith which is other or more burdensome than the taxation and connected requirements to which nationals of that State in the same circumstances are or may be subjected."

[p. 165] 19. It is possible that in the future certain States will take exception to the provisions of paragraph 3 as being too liberal insofar as they entitle stateless persons who are residents of one State to claim equality of treatment not only in the other State but also in their State of residence and thus benefit in particular in the latter from the provisions of double taxation conventions concluded by it with third States. If such States wished to avoid this latter consequence, they would have to modify paragraph 3 as follows:

"Stateless persons who are residents of a Contracting State shall not be subjected in the other Contracting State to any taxation or any requirement connected therewith which is other or more burdensome than the taxation and connected requirements to which nationals of that other State in the same circumstances are or may be subjected."

20. Finally, it should be understood that the definition of the term "stateless person" to be used for the purposes of such a clause can only be that laid down in paragraph 1 of Article 1 of the Convention of 28th September, 1954, which defines a stateless person as "a person who is not considered as a national by any State under the operation of its law".

Paragraph 4

21. Strictly speaking, the type of discrimination which this paragraph is designed to end is discrimination based not on nationality but on the actual situs of an enterprise. It therefore affects without distinction, and irrespective of their nationality, all residents of a Contracting State who have a permanent establishment in the other Contracting State.

22. It appears necessary first to make it clear that the wording of the first sentence of paragraph 4 must be interpreted in the

sense that it does not constitute discrimination to tax non-resident persons differently, for practical reasons, from resident persons, as long as this does not result in more burdensome taxation for the former than for the latter. In the negative form in which the provision concerned has been framed, it is the result alone which counts, it being permissable to adapt the mode of taxation to the particular circumstances in which the taxation is levied.

23. By the terms of the first sentence of paragraph 4, the taxation of a permanent establishment shall not be less favourably levied in the State concerned than the taxation levied on enterprises of that State carrying on the same activities. The purpose of this provision is to end all discrimination in the treatment of permanent establishments as compared with resident enterprises belonging to the same sector of activities, as regards taxes based on industrial and commercial activities, and especially taxes on business profits.

24. However, the second sentence of paragraph 4 specifies the conditions under which the principle of equal treatment set forth in the first sentence should be applied to individuals who are residents of a Contracting State and have a permanent establishment in the other State. It is designed mainly to ensure that such persons do not obtain greater advantages than residents, through entitlement to personal allowances and reliefs for family responsibilities, both in the State of which they are residents, by the application of its domestic laws, and in the other State by virtue of the principle of equal treatment. Consequently, it leaves it open to the State in which the permanent establishment is situated whether or not to give personal allowances and reliefs to the person [p. 166] concerned in the proportion which the amount of the permanent establishment's profits bears to the world income taxable in the other State.

25. As regards the first sentence, experience has shown that it was difficult to define clearly and completely the substance of the principle of equal treatment and this has led to wide differences of opinion with regard to the many implications of this principle. The main reason for difficulty seems to reside in the actual nature of the permanent establishment, which is not a separate legal entity but only a part of an enterprise that has its head office in

another State. The situation of the permanent establishment is different from that of a domestic enterprise, which constitutes a single entity all of whose activities, with their fiscal implications, can be fully brought within the purview of the State where it has its head office. The implications of the equal treatment clause will be examined below under several aspects of the levying of tax.

A. Assessment of Tax

26. With regard to the basis of assessment of tax, the principle of equal treatment normally has the following implications:

a) Permanent establishments must be accorded the same right as resident enterprises to deduct the trading expenses that are, in general, authorised by the taxation law to be deducted from taxable profits in addition to the right to attribute to the permanent establishment a proportion of the overheads of the head office of the enterprise. Such deductions should be allowed without any restrictions other than those also imposed on resident enterprises.

b) Permanent establishments must be accorded the same facilities with regard to depreciation and reserves. They should be entitled to avail themselves without restriction not only of the depreciation facilities which are customarily available to enterprises (straight line depreciation, declining balance depreciation), but also of the special systems that exist in a number of countries ("wholesale" writing down, accelerated depreciation, etc.). As regards reserves, it should be noted that these are sometimes authorised for purposes other than the offsetting—in accordance with commerical accounting principles—of depreciation on assets, expenses or losses which have not yet occurred but which circumstances make likely to occur in the near future. Thus, in certain countries, enterprises are entitled to set aside, out of taxable profit, provisions or "reserves" for investment. When such a right is enjoyed by all enterprises, or by all enterprises in a given sector of activity, it should normally also be enjoyed, under the same conditions, by non-resident enterprises, or by enterprises in a given sector of activity, it should in the State concerned, insofar, that is,

as the activities to which such provisions or reserves would pertain are taxable in that State.

c) Permanent establishments should also have the option that is available in most countries to resident enterprises of carrying forward or backward a loss brought out at the close of an accounting period with a certain period of time (e.g. 5 years). It is hardly necessary to specify that in the case of permanent establishments it is the loss on their own business activities, as shown in the separate accounts for these activities, which will qualify for such carry-forward.

d) Permanent establishments should further have the same rules applied [p. 167] to resident enterprises, with regard to the taxation of capital gains realised on the alienation of assets, whether during or on the cessation of business.

27. Although the general rules mentioned above rarely give rise to any difficulties with regard to the principle of non-discrimination, the same does not always hold good for the tax incentive measures which most countries, faced with such problems as decentralisation of industry, development of economically backward regions, or the promotion of new activities necessary for the expansion of the economy, have introduced in order to facilitate the solution of these problems by means of tax exemptions, reductions or other tax advantages given to enterprises for investment which is in line with official objectives.

28. As such measures are in furtherance of objectives directly related to the economic activity proper of the State concerned, it is right that the benefit of them should be extended to permanent establishments of enterprises of another State which has a double taxation convention with the first embodying the provisions of Article 24, once they have been accorded the right to engage in industrial or commercial activity in that State, either under its legislation or under an international agreement (treaties of commerce, establishment conventions, etc.) concluded between the two States.

29. It should, however, be noted that although non-resident enterprises are entitled to claim these tax advantages in the State concerned, they must fulfil the same conditions and requirements

as resident enterprises. They may, therefore, be denied such advantages if their permanent establishments are unable or refuse to fulfil the special conditions and requirements attached to the granting of them.

30. Finally, it goes without saying that non-resident enterprises are not entitled to tax advantages attaching to activities the exercise of which is strictly reserved, on grounds of national interest, defence, protection of the national economy, etc., to domestic enterprises, since non-resident enterprises are not allowed to engage in such activities.

B. Special Treatment of Dividends Received in Respect of Holdings Owned by Permanent Establishments

31. In many countries special rules exist for the taxation of dividends distributed between companies (parent company-subsidiary treatment, the "Schachtelprivileg", the rule "non bis in idem"). The question arises whether such treatment should by effect of the provisions of paragraph 4 also be enjoyed by permanent establishments in respect of dividends on holdings forming part of their assets.

32. On this point opinions differ. Some States consider that such special treatment should be accorded to permanent establishments. They take the view that such treatment was enacted in order to avoid double taxation on profits made by a subsidiary and distributed to a parent company. In principle profits tax should be levied once, in the hands of the subsidiary performing the profit-generating activities. The parent company should be exempted from tax on such profits when received from the subsidiary or should, under the indirect credit method, be given relief for the taxation borne by the subsidiary. In cases where shares are held as direct investment by a permanent establishment the same principle implies that such a permanent establishment receiving dividends [p. 168] from the subsidiary should likewise be granted the special treatment in view of the fact that a profits tax has already been levied in the hands of the subsidiary. On the other hand, it is hardly conceivable on this line of thought to leave it to the State where the head office of the parent company is situated to give

relief from double taxation brought about by a second levying of tax in the State of the permanent establishment. The State of the parent company, in which no activities giving rise to the doubly taxed profits have taken place, will normally exempt the profits in question or will levy a profits tax which is not sufficient to bear a double credit (i.e. for the profits tax on the subsidiary as well as for such tax on the permanent establishment). All this assumes that the shares held by the permanent establishment are effectively connected with its activity. Furthermore, an obvious additional condition is that the profits out of which the dividends are distributed should have borne a profits tax.

33. Other States, on the contrary, consider that assimilating permanent establishments to their own enterprises does not entail any obligation to accord such special treatment to the former. They justify their position on various grounds. The purpose of such special treatment is to avoid economic double taxation of dividends and it should be for the recipient company's State of residence and not the permanent establishment's State to bear its cost, because it is more interested in the aim in view. Another reason put forward related to the sharing of tax revenue between States. The loss of tax revenue incurred by a State in applying such special treatment is partly offset by the taxation of the dividends when they are redistributed by the parent company which has enjoyed such treatment (withholding tax on dividends, shareholder's tax). A State which accorded such treatment to permanent establishments would not have the benefit of such a compensation. Another argument made is that when such treatment is made conditional upon redistribution of the dividends its extension to permanent establishments would not be justified, for in such a case the permanent establishment, which is only a part of a company of another State and does not distribute dividends, would be more favourably treated than a resident company. Finally, the States which feel that paragraph 4 does not entail any obligation to extend such treatment to permanent establishments argue that there is a risk that companies of one State might transfer their holdings in companies of another State to their permanent establishments in that other State for the sole purpose of availing themselves of such treatment.

34. The fact remains that there can be very valid reasons for a holding being owned and managed by a permanent establishment rather than by the head office of the enterprise, viz.,

— reasons of necessity arising principally from a legal or regulatory obligation on banks and financial institutions and insurance companies to keep deposited in countries where they operate a certain amount of assets, particularly shares, as security for the performance of their obligations;

— or reasons of expediency, where the holdings are in companies which have business relations with the permanent establishment or whose head offices are situated in the same country as the permanent establishment;

— or simple reasons of practical convenience, in line with the present tendency towards decentralisation of management functions in large enterprises.

[p. 169] 35. In view of these divergent attitudes, as well as of the existence of the situations just described, it would be advisable for States, when concluding bilateral conventions, to make clear the interpretation they give to the first sentence of paragraph 4. They can, if they so desire, explain their position, or change it as compared with their previous practice, in a protocol or any other document annexed to the convention.

36. A solution could also be provided in such a document to meet the objection mentioned above that the extension of the treatment of holdings in a State (A) to permanent establishments of companies which are residents of another State (B) results in such companies unduly enjoying privileged treatment as compared with other companies which are residents of the same State and whose head offices own holdings in the capital of companies which are residents of State A, in that whereas the dividends on their holdings can be repatriated by the former companies without bearing withholding tax, such tax is levied on dividends distributed to the latter companies at the rate of 5 or 15 per cent as the case may be. Tax neutrality and the equality of tax burdens as between permanent establishments and subsidiary companies, as advocated by the States concerned, could be ensured by adapting, in the bilateral convention between States A and B, the provisions

of paragraphs 2 and 4 of Article 10, so as to enable withholding tax to be levied in State A on dividends paid by companies which are residents of that State to permanent establishments of companies which are residents of State B in the same way as if they are received directly i.e. by the head offices of the latter companies, viz., at the rate of:

— 5 per cent in the case of a holding of at least 25 per cent;

— 15 per cent in all other cases.

37. Should it not be possible, because of the absence of appropriate provisions in the domestic laws of the State concerned to levy a withholding tax there on dividends paid to permanent establishments, the treatment of inter-company dividends could be extended to permanent establishments, as long as its application is limited in such manner that the tax levied by the State of source of the dividends is the same whether the dividends are received by a permanent establishment of a company which is a resident of the other State or are received directly by such a company.

C. STRUCTURE AND RATE OF TAX

38. In countries where enterprises, mainly companies, are charged a tax on their profits which is specific to them, the provisions of paragraph 4 raise, with regard to the rate applicable in the case of permanent establishments, especially difficult and delicate problems, which here too arise from the fact that the permanent establishment is only a part of a legal entity which is not under the jurisdiction of the State where the permanent establishment is situated.

39. When the taxation of profits made by companies which are residents of a given State is calculated according to a progressive scale of rates, such a scale should, in principle, be applied to permanent establishments situated in that State. If in applying the progressive scale, the permanent establishment's State takes into account the profits of the whole company to which such a permanent establishment belongs, such a rule would not appear to conflict with the equal treatment rule, since resident companies are in fact treated in the same way (cf. paragraphs 55, 56 and 77

of the Commentary on Articles 23A and 23B). States [p. 170] that tax their own companies in this way could therefore define in their bilateral conventions the treatment applicable to permanent establishments.

40. When a system of taxation based on a progressive scale of rates includes a rule that a minimum rate is applicable to permanent establishments, it cannot be claimed a priori that such a rule is incompatible with the equal treatment principle. The profits of the whole enterprise to which the permanent establishment belongs should be taken into account in determining the rate applicable according to the progressive scale. The provisions of the first sentence of paragraph 4 are not observed only if the minimum rate is higher.

41. However, even if the profits of the whole enterprise to which the permanent establishment belongs is taken into account when applying either a progressive scale of rates or a minimum rate, this should not conflict with the principle of the distinct and separate enterprise, according to which the profits of the permanent establishment must be determined under paragraph 2 of Article 7. The minimum amount of the tax levied in the State where the permanent establishment is situated is, therefore, the amount which would be due if it were a distinct and separate enterprise, without reference to the profits of the whole enterprise to which it belongs. The State where the permanent establishment is situated is, therefore, justified in applying the progressive scale applicable to resident enterprises solely to the profits of the permanent establishment, leaving aside the profits of the whole enterprise when the latter are less than those of the permanent establishment. This State may likewise tax the profits of the permanent establishment at a minimum rate, provided that the same rate applies also to resident enterprises, even if taking into account the profits of the whole enterprise to which it belongs would result in a lower amount of tax, or no tax at all.

42. As regards the split-rate system of company tax, it should first be pointed out as being a fact central to the issue here that most OECD Member countries which have adopted this system do not consider themselves bound by the provisions of paragraph 4 to extend it to permanent establishments of non-resident com-

panies. This attitude is based, in particular, on the view that the split-rate is only one element amongst others (in particular a withholding tax on distributed income) in a system of taxing company profits and dividends which must be considered as a whole and is therefore, both for legal and technical reasons, of domestic application only. The State where the permanent establishment is situated could claim the right not to tax such profits at the reduced rate as, generally, it does not tax the dividends distributed by the company to which the permanent establishment belongs. Moreover, a State which has adopted a split-rate system usually has other economic policy objectives, such as the promotion of the capital market, by encouraging resident companies to distribute dividends. The extension of the reduced rate to the profits of the permanent establishment would not serve such a purpose at all, as the company distributing the dividends is not a resident of the State concerned.

43. This view is, however, disputed. The States in favour of extending the split-rate system to permanent establishments urge that as the essential feature of this system is a special technique of taxing profits which enterprises in a corporate form derive from their activities, and is designed to afford immediate relief from the double taxation levied on the profits distributed, it should be applied to permanent establishments in bilateral conventions against double taxation. It is generally recognised that, by the effects of their provisions, such [p. 171] conventions necessarily result in some integration of the taxation systems of the Contracting States. On this account, it is perfectly conceivable that profits made in a State (A) by a permanent establishment of a company resident in another State (B) should be taxed in State A according to the split-rate system. As a practical rule, the tax could in such case be calculated at the reduced rate (applicable to distributed profits) on that proportion of an establishment's profits which corresponds to the ratio between the profit distributed by the company to which it belongs and the latter's total profit; the remaining profit could be taxed at the higher rate. Of course, the two Contracting States would have to consult together and exchange all information necessary for giving practical effect to this solution. Similar considerations apply to systems where

distributions of profits made can be deducted from the taxable income of a company.

44. As regards the imputation system ("avoir fiscal" or "tax credit"), it seems doubtful, at least on a literal interpretation of the provisions of paragraph 4, whether it should be extended to non-resident companies in respect of dividends paid out of profits made by their permanent establishments. In fact, it has identical effects to those of the split-rate system but these effects are not immediate as they occur only at the time of the shareholder's personal taxation. From a purely economic and financial standpoint, however, it is conceivable that such profits should be treated as though they were profits of a distinct company in State A where the permanent establishment of a company which is a resident of State B is situated, and, to the extent that they are distributed, carry the "avoir fiscal" or "tax credit". But to take the matter further, to avoid all discrimination it is necessary that this advantage should already have been accorded to shareholders who are residents of State B of companies which are residents of State A. From the practical standpoint, the two States concerned should, of course, agree upon the conditions and procedures for allowing the "avoir fiscal" or "tax credit" to shareholders who are themselves residents of either State, of the companies concerned that are residents of State B.

45. Contracting States which are faced with the problems described above may settle them in bilateral negotiations in the light of their peculiar circumstances.

D. Withholding Tax on Dividends, Interest and Royalties Received by a Permanent Establishment

46. When permanent establishments receive dividends, interest, or royalties such income, by virtue of paragraph 4 of Articles 10 and 11 and paragraph 3 of Article 12, respectively, comes under the provisions of Article 7 and consequently — subject to the observations made in paragraph 36 above as regards dividends received on holdings of permanent establishment — falls to be included in the taxable profits of such permanent establishments (cf. paragraph 34 of the Commentary on Article 7).

47. According to the respective Commentaries on the above-mentioned provisions of Articles 10, 11 and 12 (cf. respectively paragraphs 30, 22 and 15), these provisions dispense the State of source of the dividends, interest or royalties received by the permanent establishment from applying any limitation provided for in those Articles, which means — and this is the generally accepted interpretation — that they leave completely unaffected the right of the State of source, where the permanent establishment is situated, to apply its withholding tax at the full rate.

[p. 172] 48. While this approach does not create any problems with regard to the provisions of paragraph 4 of Article 24 in the case of countries where a withholding tax is levied on all such income, whether the latter be paid to residents (permanent establishments, like resident enterprises, being allowed to set such withholding tax off against the tax on profits due by virtue of Article 7) or to non-residents (subject to the limitations provided for in Articles 10, 11 and 12), the position is different when withholding tax is applied exclusively to income paid to non-residents.

49. In this latter case, in fact, it seems difficult to reconcile the levy of withholding tax with the principle set out in paragraph 4 that for the purpose of taxing the income which is derived from their activity, or which is normally connected with it — as is recognised to be the case with dividends, interest and royalties referred to in paragraph 4 of Articles 10 and 11 and in paragraph 3 of Article 12 — permanent establishments must be treated as resident enterprises and hence in respect of such income be subjected to tax on profits solely.

50. In any case, it is for Contracting States which have this difficulty to settle it in bilateral negotiations in the light of their peculiar circumstances.

E. Credit for Foreign Tax

51. In a related context, when a permanent establishment receives foreign income which is included in its taxable profits, it is right by virtue of the same principle to grant to the permanent establishment credit for foreign tax borne by such income when such credit is granted to resident enterprises under domestic laws.

52. If in a Contracting State (A) in which is situated a permanent establishment of an enterprise of the other Contracting State (B) credit for tax levied in a third State (C) can be allowed only by virtue of a convention, then the more general question arises, as to the extension to permanent establishments of the benefit of conventions concluded with third States, which is examined in paragraph 54 below.

53. It should, however, be pointed out that difficulties may arise as to the amount of the credit to be allowed, if permanent establishments in State A benefit from the convention which State B has concluded with State C. Such amount may be either the amount of tax effectively collected by State C or the amount of tax which State C may collect by virtue either of its convention with State A or its convention with State B. Moreover, the question arises whether such credit is not given twice, i.e. once in State A, where the permanent establishment is situated and again in State B, the State of residence. It is for Contracting States to settle such problems, if necessary, in their bilateral negotiations.

F. Extension to Permanent Establishments of the Benefit of Double Taxation Conventions Concluded with Third States

54. While an enterprise of a State (A) can normally claim, in respect of the permanent establishment which it possesses in another State (B), the benefit of the provisions of the convention between those two States A and B, it nevertheless cannot, should such permanent establishment derive income from a third State (C), invoke the provisions of the convention between States B and C for the [p. 173] benefit of such permanent establishment since it, the enterprise, is in fact resident of neither of those two States (cf. Article 1). This is the consequence of the well-known principle of the relative effect of treaties, which means that they have effect only as between the Contracting States.

55. Nor could such an enterprise invoke for this purpose a most-favoured-nation clause, however general its terms, included

in a treaty or agreement concluded between States A and B. In fact, it has always been accepted that such a clause did not apply in the case of double taxation conventions because these are essentially based on the principle of reciprocity. It should, however, be noted that some States have made provision in their double taxation conventions enabling the provisions of the latter to be applied, "in special cases", to permanent establishments of enterprises of a third State.

Paragraph 5

56. This paragraph is designed to end a particular form of discrimination resulting from the fact that in certain countries the deduction of interest, royalties and other disbursements allowed without restriction when the recipient is resident, is restricted or even prohibited when he is a non-resident. The same situation may also be found in the sphere of capital taxation, as regards debts contracted to a non-resident. It is however open to Contracting States to modify this provision in bilateral conventions to avoid its use for tax avoidance purposes.

Paragraph 6

57. This paragraph forbids a Contracting State to give less favourable treatment to an enterprise, the capital of which is owned or controlled, wholly or partly, directly or indirectly, by one or more residents of the other Contracting State. This provision, and the discrimination which it puts an end to, relates to the taxation only of enterprises and not of the persons owning or controlling their capital. Its object therefore is to ensure equal treatment for taxpayers residing in the same State, and not to subject foreign capital, in the hands of the partners or shareholders, to identical treatment to that applied to domestic capital.

Paragraph 7

58. This paragraph states that the scope of the Article is not restricted by the provisions of Article 2. The Article therefore applies to taxes of every kind and description levied by, or on behalf of, the State, its political subdivisions or local authorities.

Observations on the Commentary

59. The interpretation given in paragraphs 40 and 41 above is not endorsed by *Germany*, the tax laws of which require the application of a minimum rate with respect to non-residents. Under German tax laws, the profits of a permanent establishment of an enterprise operated in Germany by a non-resident individual are charged income tax at a minimum rate of 25 per cent. On the other hand, the German tax laws restrict the application of higher rates by strictly limiting the basis for determining the rate applicable to profits derived from German sources — thus excluding any profits derived by those parts of the enterprise which are situated abroad. Moreover, since the minimum rate of 25 percent is close to [p. 174] the lower end of the progressive tax scale which ranges from 22 per cent to 56 per cent, Germany is of the opinion that the application of the minimum rate of 25 per cent does not violate the provisions of paragraph 4.

60. The *United States* observes that its non-resident citizens are not in the same circumstances as other non-residents, since the United States taxes its non-resident citizens on their worldwide income.

Reservations on the Article

61. *Australia, Canada* and *New Zealand* reserve their positions on this Article.

Paragraph 1

62. *France* accepts the provisions of paragraph 1 but wishes to reserve the possibility of granting only to French nationals the exemption, provided for in its domestic laws, of gains from the alienation of immovable property which constitutes, whether in whole or in part, the residence in France of French nationals who are domiciled abroad.

63. The *United Kingdom* reserves its position on the second sentence of paragraph 1.

Paragraph 4

64. *Belgium* reserves the right to apply the provisions of its internal law for the purpose of taxing the profits of Belgian permanent establishments of companies and associations resident in countries with which it undertakes negotiations, whenever such an attitude is warranted by the general treatment accorded in such countries to permanent establishments of companies and associations resident in Belgium (paragraph 4).

65. *Japan* reserves the right not to extend to the permanent establishments of non-residents the benefit of tax incentive measures introduced for national policy objectives.

Paragraph 5

66. France accepts the provisions of paragraph 5 but wishes to reserve the possibility of applying the provisions in its domestic laws relative to the limitation to the deduction of interest paid by a French company to a foreign parent company.

* * *

EXHIBIT 45

[p. 223-3] TREASURY DEPARTMENT'S MODEL INCOME TAX TREATY OF MAY 17, 1977

[¶ 153]

CONVENTION BETWEEN THE GOVERNMENT OF THE UNITED STATES OF AMERICA AND THE GOVERNMENT OF .... FOR THE AVOIDANCE OF DOUBLE TAXATION AND THE PREVENTION OF FISCAL EVASION WITH RESPECT TO TAXES ON INCOME AND CAPITAL

The Government of the United States of America and the Government of ...., desiring to conclude a convention for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income and capital, have agreed as follows:

* * *

Article 2
TAXES COVERED

[p. 223-3] 1. This Convention shall apply to taxes on income and on capital imposed on behalf of a Contracting State.

2. The existing taxes to which this Convention shall apply are:

(a) In the United States: the Federal income taxes imposed by the Internal Revenue Code and the excise taxes imposed on insurance premiums paid to foreign insurers and with respect to private foundations, but excluding the accumulated earnings tax and the personal holding company tax.

(b) In ....: ....

3. The Convention shall apply also to any identical or substantially similar taxes which are imposed by a Contracting State after the date of signature of this Convention in addition to, or in place of, the existing taxes. The competent authorities of the Contracting States shall notify each other of any changes which have

been made in their respective taxation laws and shall notify each other of any official published material concerning the application of this Convention, including explanations, regulations, rulings, or judicial decisions.

[p. 224] 4. For the purpose of Article 24 (Non-Discrimination), this Convention shall also apply to taxes of every kind and description imposed by a Contracting State or a political subdivision or local authority thereof. For the purpose of Article 26 (Exchange of Information and Administrative Assistance), this Convention shall also apply to taxes of every kind imposed by a Contracting State.

* * *

[p. 225] TREASURY'S MODEL CONVENTION

Article 5

PERMANENT ESTABLISHMENT

1. For the purposes of this Convention, the term "permanent establishment" means a fixed place of business through which the business of an enterprise is wholly or partly carried on.

2. The term "permanent establishment" shall include especially:

(a) a branch;

(b) an office;

(c) a factory;

(d) a workshop; and

(e) a mine, an oil or gas well, a quarry, or any other place of extraction of natural resources.

3. A building site or construction or installation project, or an installation or drilling rig or ship used for the exploration or development of natural resources, constitutes a permanent establishment only if it lasts more than 24 months.

4. Notwithstanding the preceding provisions of this Article, the term "permanent establishment" shall be deemed not to include:

(a) the use of facilities solely for the purpose of storage, display, or delivery of goods or merchandise belonging to the enterprise;

(b) the maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of storage, display or delivery;

(c) the maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of processing by another enterprise;

(d) the maintenance of a fixed place of business solely for the purpose of purchasing goods or merchandise, or of collecting information, for the enterprise;

(e) the maintenance of a fixed place of business solely for the purpose of carrying on, for the enterprise, any other activity of a preparatory or auxiliary character;

(f) the maintenance of a fixed place of business solely for any combination of the activities mentioned in subparagraphs (a) to (e) of this paragraph.

5. Notwithstanding the provisions of paragraphs 1 and 2, where a person—other than an agent of an independent status to whom paragraph 6 applies—is acting on behalf of an enterprise and has and habitually exercises in a Contracting State an authority to conclude contracts in the name of the enterprise, that enterprise shall be deemed to have a permanent establishment in that State in respect of any activities which that person undertakes for the enterprise, unless the activities of such person are limited to those mentioned in paragraph 4 which, if exercised through a fixed place of business, would not make this fixed place of business a permanent establishment under the provisions of that paragraph.

6. An enterprise shall not be deemed to have a permanent establishment in a Contracting State merely because it carries on

business in that State through a broker, general [p. 226] commission agent or any other agent of an independent status, provided that such persons are acting in the ordinary course of their business.

7. The fact that a company which is a resident of a Contracting State controls or is controlled by a company which is a resident of the other Contracting State, or which carries on business in that other State (whether through a permanent establishment or otherwise), shall not of itself constitute either company a permanent establishment of the other.

* * *

Article 7

BUSINESS PROFITS

1. The business profits of an enterprise of a Contracting State shall be taxable only in that State unless the enterprise carries on business in the other Contracting State through a permanent establishment situtated therein. If the enterprise carries on business as aforesaid, the business profits of the enterprise may be taxed in the other State but only so much of them as is attributable to that permanent establishment.

2. Subject to the provisions of paragraph 3, where an enterprise of a Contracting State carries on business in the other Contracting State through a permanent establishment situated therein, there shall in each Contracting State be attributed to that permanent establishment the business profits which it might be expected to make if it were a distinct and independent enterprise engaged in the same or similar activities under the same or similar conditions.

3. In determining the business profits of a permanent establishment, there shall be allowed as deductions expenses which are incurred for the purposes of the permanent establishment, including a reasonable allocation of executive and general administrative expenses, research and development expenses, interest, and other expenses incurred for the purposes of the enterprise as a whole (or the part thereof which includes the permanent establishment), whether incurred in the State in which the permanent establishment is situated or elsewhere.

4. No business profits shall be attributed to a permanent establishment by reason of the mere purchase by that permanent establishment of goods or merchandise for the enterprise.

5. For the purposes of the preceding paragraphs, the business profits to be attributed to the permanent establishment shall be determined by the same method year by year unless there is good and sufficient reason to the contrary.

6. Where business profits include items of income which are dealt with separately in other Articles of this Convention, then the provisions of those Articles shall not be affected by the provisions of this Article.

[p. 227] 7. For the purposes of this Convention, "business profits" means income derived from any trade or business whether carried on by an individual, company or any other person, or group of persons, including the rental of tangible personal (movable) property, and the rental or licensing of cinematograph films or films or tapes used for radio or television broadcasting.

* * *

Article 9

ASSOCIATED ENTERPRISES

1. Where

(a) an enterprise of a Contracting State participates directly or indirectly in the management, control or capital of an enterprise of the other Contracting State, or

(b) the same persons participate directly or indirectly in the management, control or capital of an enterprise of a Contracting State and an enterprise of the other Contracting State,

and in either case conditions are made or imposed between the two enterprises in their commercial or financial relations which differ from those which would be made between independent enterprises, then any profits which would, but for those conditions, have accrued to one of the enterprises, but, by reason of

those conditions, have not so accrued, may be included in the profits of that enterprise and taxed accordingly.

2. Where a Contracting State includes in the profits of an enterprise of that State, and taxes accordingly, profits on which an enterprise of the other Contracting State has been charged to tax in that other State, and the profits so included are profits which would have accrued to the enterprise of the first-mentioned State if the conditions made between the two enterprises had been those which would have been made between independent enterprises, then that other State shall make an appropriate adjustment to the amount of the tax charged therein on those profits. In determining such adjustment, due regard shall be had to the other provisions of this Convention and the competent authorities of the Contracting States shall if necessary consult each other.

3. The provisions of paragraph 1 shall not limit any provisions of the law of either Contracting State which permit the distribution, apportionment or allocation of income, deductions, credits, or allowances between persons owned or controlled directly or indirectly by the same interests when necessary in order to prevent evasion of taxes or clearly to reflect the income of any of such persons.

* * *

[p. 233] TREASURY'S MODEL CONVENTION

Article 24

NON-DISCRIMINATION

1. Nationals of a Contracting State shall not be subjected in the other State to any taxation or any requirement connected therewith, which is other or more burdensome than the taxation and connected requirements to which nationals of that other State in the same circumstances are or may be subjected. For purposes of the preceding sentence, nationals who are subject to tax by a Contracting State on worldwide income are not in the same circumstances as nationals who are not so subject. This provision shall, notwithstanding the provisions of Article 1 (Personal Scope), also apply to persons who are not residents of one or both of the Contracting States.

2. The term "nationals" means:

(a) in relation to ....

....

....

(b) in relation to the United States, United States citizens.

3. The taxation on a permanent establishment which an enterprise of a Contracting State has in the other Contracting State shall not be less favorably levied in that other State than the taxation levied on enterprises of that other State carrying on the same activities. This provision shall not be construed as obliging a Contracting State to grant to residents of the other Contracting State any personal allowances, reliefs and reductions for taxation purposes on account of civil status or family responsibilities which it grants to its own residents.

4. Except where the provisions of paragraph 1 of Article 9 (Associated Enterprises), paragraph 5 of Article 11 (Interest), or paragraph 4 of Article 12 (Royalties) apply, interest, royalties and other disbursements paid by an enterprise of a Contracting State to a resident of the other Contracting State shall, for the purpose of determining the taxable profits of such enterprise, be deducti-

ble under the same condition as if they had been paid to a resident of the first-mentioned State. For purposes of this paragraph, the term "other disbursements" shall include charges for amounts expended by such residents for purposes of such enterprise, including a reasonable allocation of executive and general administrative expenses (except to the extent representing the expenses of a type of activity which is not for the benefit of such enterprise, but constitute "stewardship" or "over-seeing" functions undertaken for such resident's own benefit as an investor in the enterprise), research and development, and other expenses incurred by such resident for the benefit of a group of related enterprises including such enterprise. Similarly, any debts of an enterprise of a Contracting State to a resident of the other Contracting State shall, for the purpose of determining the taxable capital of such enterprise, be deductible under the same conditions as if they had been contracted to a resident of the first-mentioned State.

5. Enterprises of a Contracting State, the capital of which is wholly or partly owned or controlled, directly or indirectly, by one or more residents of the other Contracting State, shall not be subjected in the first-mentioned State to any taxation or any requirement connected therewith which is other or more burdensome than the taxation and connected requirements to which other similar enterprises of the first-mentioned State are or may be subjected.

6. The provisions of this Article shall, in accordance with the provisions of paragraph 4 of Article 2 (Taxes Covered), apply to taxes of every kind and description imposed by a Contracting State or a political subdivision or local authority thereof.

EXHIBIT 46C

DEPARTMENT OF THE TREASURY
Washington, D.C. 20220

Apr. 22, 1980

Dear Barber:

In response to your letter of March 31, 1980, I am enclosing replies to the five questions you raised on the relationship between the unitary apportionment issue and our tax treaty negotiations.

Sincerely,

/s/ Donald L. Lubick

Donald C. Lubick

The Honorable
Barber B. Conable, Jr.
House of Representatives
Washington, D.C 20515

Enclosure

Questions on the Relationship Between the Unitary Apportionment Method and U.S. Tax Treaty Negotiations

Question 1:

Can you tell the Committee how treaty negotiations are being affected by the Unitary concept?

Answer:

Many countries with which we have had tax treaty negotiations in recent years have expressed serious concern about the application of unitary apportionment systems to corporate groups based in their countries. Our inability to provide a positive response to this concern weakens, somewhat, our overall bargaining position in negotiations. This is particularly true in cases where we are seeking relief from state or local taxes in the other country. Thus, there is a cost to the United States in our inability to satisfy other countries on this issue.

Question 2:

Does it appear as though another attempt will be made to limit the application of the Unitary method by treaty?

Answer:

We continue to believe that Article 9(4) in the U.K. treaty as originally negotiated represented an appropriate use of the treaty making authority. We do not, however, presently intend to put such a provision in any treaty currently under negotiation. While I would not foreclose the possibility of doing so at some time in the future, we wish to see what action will be taken on H.R. 5076 as well as similar bills in state legislatures.

Question 3:

Although the Unitary method limitation in the US-UK income treaty was defeated, has the UK indicated any interest in reviving the issue?

Answer:

The Senate reservation on the unitary apportionment limitation provision of the U.S.-U.K. treaty (Article 9(4) raised serious concerns in the U.K. as to the advisability of the U.K. ratifying the treaty. This issue held up U.K. Parliamentary approval of the treaty while a number of Conservative M.P.'s satisfied themselves that adequate steps were being taken in the U.S. (in Congress, state legislatures, and the courts) to resolve the issue. After heated Parliamentary debate, the treaty was approved. However, at the time of the exchange of instruments of ratification, the British Government sent a formal diplomatic note stating its continuing concern over the unitary apportionment issue and requesting that the Government of the United States "use its best endeavors to eliminate the international application of the unitary basis of taxation."

Question 4:

The Joint Committee's pamphlet notes that during recent treaty discussions with the French, the Unitary method was discussed. Can you elaborate on these discussions and tell the Committee if any other Governments have raised the Unitary tax issue with the Treasury?

Answer:

The unitary apportionment issue was discussed at length during the negotiation of the recent Protocol to the U.S.-French income tax Convention. The French negotiators accepted the fact that, on the basis of our experience with the U.K. treaty, the Treasury was unable to achieve ratification of a Protocol limiting unitary apportionment. They insisted, however, on an exchange of notes calling attention to French concern and obligating the United States to reopen discussions with France on this subject if an acceptable provision can be devised. A copy of the relevant paragraphs of that note is attached.

A number of other countries have also raised this issue. Denmark, Italy, Germany and Canada have made strong representations during tax treaty negotiations. The Netherlands and

Italy (on behalf of the EEC member countries) have sent formal diplomatic notes on this subject.

Question 5:

In your judgement does the Unitary method work mostly to the detriment of domestic or foreign business?

Answer:

The application of the Unitary method to non-U.S. members of a corporate group raises three fundamental problems: (1) It may distort the measurement of income for state tax purposes; (2) it imposes a difficult administrative burden on the taxpayer, who must provide information in the language and currency of the jurisdiction applying the method with respect to a large number of related companies; and (3) it is an irritant in U.S. relations with a number of other countries. The first of these problems applies equally to both U.S. and foreign based corporate groups. The second and third apply principally to foreign based groups. Thus, while the application of the method raises problems for all multinational groups, foreign based groups are more seriously affected than groups controlled by a U.S. parent.

Excerpts from U.S.-France Exchange of Notes

2. It is the position of the Government of France that the so-called "unitary apportionment" method used by certain states of the United States to allocate income to the United States offices or subsidiaries of French corporations, results in inequitable taxation and imposes excessive administrative burdens on French corporations doing business in those states. Under that method the profit of a French company on its United States business is not determined on the basis of arm's length relations but is derived from a formula taking account of the income of the French company and its worldwide subsidiaries as well as the assets, payroll, and sales of all such companies.

For a French multinational corporation with many subsidiaries in different countries to have to submit its books and records for

all of these corporations to a United States state, in English, imposes a costly burden.

It is understood that the Senate of the United States has not consented to any limitation on the taxing jurisdiction of the states by treaty and that a provision which would have restricted the use of unitary apportionment in the case of United Kingdom corporations was recently rejected by the Senate. The Government of France continues to be concerned about this issue as it affects French multinationals. If an acceptable provision on this subject can be devised, the United States agrees to reopen discussions with France on this subject.

CONGRESS OF THE UNITED STATES
[HOUSE OF REPRESENTATIVES]
[LETTERHEAD]
Washington, D.C. 20515

March 31, 1980

Donald C. Lubick
Assistant Secretary of Tax Policy
Department of the Treasury
15th and Pennsylvania Avenue
Washington, D.C. 20220

Dear Don,

Thank you for your recent testimony on H.R. 5076 concerning States' taxation of foreign source income, which I co-sponsored with Representative Jones.

After reviewing your written statement I ahve several questions that I'd like you to answer relating to the effect this issue may have on our treaty negotiations. I am attaching the questions to this letter.

Sincerely,

BARBER B. CONABLE, JR.
Member of Congress

1. Can you tell the Committee how treaty negotiations are affected by the Unitary concept?

2. Does it appear as though another attempt will be made during the application of the Unitary method by treaty?

3. Although the Unitary method limitation in the US-UK income treaty was defeated, has the UK indicated any interest in reviving the issue?

4. The Joint Committee's pamphlet notes that during recent treaty discussions with the French, the Unitary method was discussed. Can you elaborate on these discussions and tell the Committee if any other Governments have raised the Unitary tax issue with the Treasury?

5. In your judgement does the Unitary method work mostly to the detriment of domestic or foreign business?

EXHIBIT 46D

United States Department of State
Washington, D.C. 20520

July 30, 1985

To Whom It May Concern:

I, Frank M. Machak, state the following:

I am Chief, Information Access and Services Division, Foreign Affairs Information Management Center, and am responsible for the maintenance of the records of the U.S. Department of State.

The attached document hereunto annexed is a true copy of a document retrieved from the files of the Department of State.

I declare, under penalty of perjury, that the foregoing statements are true and correct.

/s/ FRANK M. MACHAK
Frank M. Machak
Chief, Information Access
and Services Division

Attachment:

Statement by Allen Wallis (Under Secretary of State for Economic Affairs) Concerning the Chairman's Working Group Report, taken from the Final Report of the Worldwide Unitary Taxation Working Group, August 1984.

UNDER SECRETARY OF STATE
FOR ECONOMIC AFFAIRS
WASHINGTON

STATEMENT BY ALLEN WALLIS CONCERNING THE CHAIRMAN'S WORKING GROUP REPORT

I support the Working Group's recommendation for a "water's edge" limitation on unitary taxation, which I believe will resolve much of the controversy surrounding this issue.

The unitary method of estimating taxable income has provoked sharp criticism from all of our major trading partners. Indeed, Secretary Shultz has said that in his tenure at the State Department few issues have provoked so broad and intense a reaction from foreign nations. The United States Government has received diplomatic notes from fourteen member countries of the Organization for Economic Cooperation and Development (OECD), either directly or through the European community, as well as communications from the OECD itself, all protesting against the application of the unitary tax method to their companies. The OECD countries account for nearly 90% of foreign direct investment in the United States, over 70% of total United States investment abroad and over 80% of United States trade (OECD figures).

Representations have been made at the highest level. The Prime Ministers of three of our largest trading partners have written to the President to express their concern and have raised the issue in personal meetings with him. The Foreign Ministers of these countries also have raised the issue with Secretary Shultz.

Our trading partners have five principal criticisms, all of which are sound:

1. The unitary tax method imposes an onerous administative burden, particularly for foreign-based multinationals.

The financial records of foreign-based companies are not kept in dollars or in English or in accordance with U.S. accounting standards, but states imposing the worldwide method require that

the worldwide earnings of a multinational be reported in these terms. Fluctuating exchange rates further complicate the picture. Although foreign subsidiaries of U.S.-based firms report to their parents in dollars, they too incur significant burdens in standardizing their reports.

2. The unitary tax method leads inevitably to extra-territorial and double taxation.

The underlying assumption of the unitary method is that there are uniform returns to sales, property and payroll throughout the world, but international investment occurs precisely because such returns differ throughout the world. Where there is greater risk, there would be little incentive to invest without relatively high rates of return as a compensation. The worldwide unitary method allows a state to reach beyond its borders and tax higher profits earned elsewhere.

Tax rates imposed by central governments vary, and often are higher in foreign countries than in the United States. Although we have concluded tax treaties with our major trading partners to avoid double taxation at the Federal level, no such arrangements exist for state taxes. Thus, for our own companies, income that is already taxed abroad is fully exposed to state taxation through application of the unitary tax method. Some foreign-based companies find themselves unable, in countries levying taxes on a territorial basis, to obtain tax credits for taxes paid to states using the unitary method on income earned in those countries.

3. The unitary tax method is contrary to international practice.

Formula apportionment (as unitary taxation is also called) was rejected as an international standard by the League of Nations many years ago. Instead, the United States actively has supported adoption of separate accounting, with arms-length adjustment, as the international standard. Years of effort by all the OECD member nations resulted in agreement on the OECD model Tax Convention which calls for separate or "arm's length" accounting, a method that more nearly corresponds with the way business is actually conducted.

4. Use of the unitary tax method by states of the United States encourages the developing countries to adopt the same method.

The developing countries share many of the same concerns about transfer pricing that certain states use to justify their use of unitary taxation, and these countries are being urged by some to adopt the unitary tax method. This would have a major impact on U.S. investment in these countries. The formulas and definitions such countries might use would be unlikely to result in fair and reasonable apportionment of taxable income. One result would be a reduction in flows of equity investment to the developing countries.

5. The unitary tax method discourages investment in those states that apply unitary taxation. It also discourages investment in the United States generally since any state may adopt the tax method.

This last point requires special emphasis.

In September 1983, President Reagan stated that the fundamental premise of our international investment policy is that foreign investment flows which respond to private market forces will lead to more efficient international production and thereby benefit both home and host countries. The President also noted that as the premier home and host country for foreign direct investment, the United States has a substantial interest in the conditions under which those flows occur.

Foreign governments have informed us that, "The (unitary tax) method can chill international investment and decrease efficient allocation of resources and employment opportunities. In particular, the unitary method can impede foreign entry into the United States market." In their view a unitary tax constitutes "... a serious obstacle to the further development of our trade and investment relationships." (Note signed by the Ambassadors of fourteen of our major trading partners). There have also been calls for retaliation.

Added to this are the statements from foreign business organizations like the Keidanren, which represents over 800 Japanese corporations: 'Unitary taxation is the single most serious deterrent to new investment by Japanese enterprises in some states of the United States." The French Patronat, which represents a wide range of the biggest French industries with investment in the United States, described the unitary taxation method in a de-

marche to our Ambassador in Paris as "...not suited to the reality nor to the development of foreign investment, particularly between industrialized countries."

State government officials have also criticized the effects of unitary taxation. The unitary basis of taxation "...is contrary to the long established traditional spirit of welcoming foreign investment in the United States....We urge those states which have the law to repeal it." (News release of the American States Offices Association, whose members represent 21 states' offices and port authorities in Japan, 12/15/83). "Within six months of the passage of... not only have major investments been put on hold or cancelled, but... (worldwide unitary taxation) not only have major investments been put on hold or cancelled, but... the state's new tax policy is a major negative factor with more than half of the state's economic development prospects....The state should take action as quickly as possible to eliminate this controversy." (March 1984 report of the Florida Unitary Tax Study Commission).

The benefits of new investment in terms of jobs, economic development and tax revenue are clear, and competition among the states for such investment is intense. Oregon already has repealed its worldwide unitary tax measure, as Illinois did earlier. Florida and Indiana probably will do so soon. All were responding to the concerns of present and potential multinational investors.

I believe that the Working Group's recommendations are in the best interest of the individual states, and of the United States, which has consistently sought to support fair and consistent treatment of international investment. I urge those states which now apply the unitary tax method to carry out the Working Group's recommendations promptly.

Allen Wallis

EXHIBIT 46E

<u>FOR RELEASE UPON DELIVERY</u>
9:00 a.m. (E.D.T.)
June 24, 1980

STATEMENT OF THE HONORABLE DONALD C. LUBICK ASSISTANT SECRETARY OF THE TREASURY FOR TAX POLICY BEFORE THE SENATE FINANCE SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT ON S. 983 AND S. 1688

Mr. Chairman and members of this distinguished Committee:

It is a pleasure to appear before this Committee to discuss the Treasury Department's views concerning the issues raised by S. 983 and S. 1688 regarding state taxation of foreign source income. The primary objective of S. 983 transcends the foreign income issue; the bill would establish national standards governing state taxation of interstate commerce. While the issues associated with this broader objective are very important, they are not, strictly speaking, Federal tax policy issues. Accordingly, my comments will be confined to the foreign income issues raised by the two bills. S. 983 and S. 1688 would clarify the extent to which a state, or political subdivision, may take account of certain income from sources outside the United States in imposing its income tax.

Each bill has two distinct parts, one dealing with state unitary apportionment taxation systems as applied to essentially foreign corporations and the other dealing with state taxation of foreign source income. Regarding the foreign source income part, S. 1688 is restricted to dividends received from a foreign corporation whereas S. 983 also applies to interest, rents, royalties, license and technical fees, and gains from a foreign source.

Under the unitary method of apportionment, as applied in several states, the income of a corporation doing business in a state is determined for state income tax purposes by applying a formula which usually includes the income, payroll, property, and

sales of the corporation subject to tax, as well as all related corporations which are considered part of a unitary business. Thus, the income of a corporation doing business in a state is determined by dividing or apportioning the total domestic and foreign income for the controlled corporate group according to the relation between the corporation's in-state activities and the world-wide activities of the entire corporate group. Unitary apportionment may be contrasted with the typical formula apportionment method used by nearly all the states which divides or apportions the income of a single corporation in relation to its business activities in the jurisdictions in which it operates. A unitary business generally exists where there is (1) common ownership; (2) centralized operation, such as purchasing, advertising, and accounting; and (3) a centralized executive force. No distinction is made, in some states, between U.S. and foreign corporations or between corporate groups controlled by U.S. corporations and those controlled by foreign corporations. The unitary apportionment part of S. 983 and S. 1688 is aimed at the practice of including foreign corporations in the unitary apportionment system.

This practice creates three types of problems. First, it may result in a determination of income for state tax purposes which is substantially different than the income which would be attributed to the corporation doing business in the state on an arm's-length or separate accounting basis. To the extent that the relationship between the apportionment factors (usually payroll, property, and sales) and the income to be apportioned differs markedly in foreign countries from the relationship which generally applies within the United States, the measurement of income by this method can result in serious distortions. In practice, the unitary apportionment system appears to generate substantially more tax revenue for the states than does the arm's length or separate accounting method. Second, the practice may impose a substantial administrative burden on a taxpayer, involving annual translation of the books of a large number of foreign corporations into U.S. accounting concepts and U.S. currency. Third, the practice has created, and continues to create, an irritant in the international relations of the United States. A number of foreign governments have complained, both officially and informally, that the

unitary system differs from the arm's-length method which is used by the Federal Government and is generally accepted in international practice.

Although the restrictions on the unitary apportionment method in the two bills differ, the intent is the same: to prohibit application of the unitary method to essentially foreign corporations. Section 303(b) of S. 983 provides that in determining a corporation's taxable income on a combined or consolidated basis, no state may require and no corporation may elect that the combined affiliated group include any corporation deriving substantially all of its income from sources outside the United States. A corporation fulfills the "substantially all" test if at least 80 percent of its gross income if derived from sources outside the United States over the preceding three-year period. Although Section 303(b) would apply to either domestic or foreign corporations, the 80 percent test demonstrates that it is designed to prohibit application of the unitary method to corporations with basically foreign operations. The unitary portion of S. 1688, reflected in paragraphs (a) through (d) of a proposed new section 7518 of the Internal Revenue Code, would prohibit any state or political subdivision, in imposing tax on any corporation, from taking into account in its unitary apportionment formula the income of any foreign corporation which is a member of an affiliated group including the foreign corporation and the corporation subject to tax, unless the income of "the corporation" (presumably the foreign corporation) is subject to Federal income tax.

Although neither bill distinguishes between corporate groups under Unites States control and those under foreign control, such a distinction may be warranted. Of the three types of problems created by the international application of the unitary method of apportionment, only the first — the potential for a distorted measurement of taxable income — applies fully with respect to U.S. based multinational groups. U.S. parent corporations are already required to submit annual financial statements to the IRS with respect to their overseas subsidiaries. Thus, the administrative burdens which the unitary system creates for foreign based corporate groups are not present to the same degree for a U.S. controlled group. Similarly, the application of a unitary system to

U.S. controlled corporate groups represents much less of an international irritant, if in fact that problem is present at all.

The Treasury Department supports the goals of S. 983 and S. 1688 with respect to affiliated groups controlled by foreign persons. We do not oppose the provisions of these bills insofar as U.S. controlled corporate groups are concerned.

There are, however, several technical problems in paragraphs (a) through (d) of the proposed section 7518 which should be addressed. We have pointed these problems out in a written submission to the Chairman of the House Committee on Ways and Means regarding H.R. 5076, which is identical to S. 1688. We would, of course, be pleased to work with the staff of this Committee in any further drafting that is undertaken.

Each of these bills would also restrict state taxation of income received by a corporation from a foreign source. S. 983 would apply to foreign source income generally, but S. 1688 is restricted to dividends. Forty-six states, including the District of Columbia, levy taxes with respect to corporate income; these taxes are either denominated as income taxes or as excise or franchise taxes measured by income. Only a few states have special rules for the taxation of foreign source income, that is, income from sources outside the United States. In most states, the treatment of foreign source income is determined by the general rules applied by the states for taxing the income of a corporation which operates accross state or national boundaries.

Taxable dividends, interest, rents, royalties, and other items of income received by a corporation, whether domestic or foreign source, usually are apportioned by formula if they are considered business income. Formula apportionment is a method for dividing the tax base among the states, in which the share to be assigned to a particular state is determined by reference to one or more ratios in which economic values or activities of the taxpayer within the state are compared with the taxpayer's total activities or values of the same kind everywhere. (The unitary method discussed above is a special case of formula apportionment in that the formula is applied to the entire affiliated corporate group, rather than to a single corporation.) States differ in how they define business

income. Some presumptively consider nearly all income to be business income. Others define business income less broadly by following the definition of business income less broadly by following the definition of business income in the Uniform Division of Income for Tax Purposes Act. It is:

> . . . income arising from transactions and activity in the regular course of the taxpayer's trade or business [including] . . . income from tangible and intangible property if the acquisition, management and disposition of the property constitute integral parts of the taxpayer's regular trade or business operations.

Under this narrower definition of business income, most items of nonoperating income would be considered nonbusiness income and would be specifically allocated

Allocation is the attribution of an income item to a specific geographic category; the particular income is thus attributed wholly to a given state, or is wholly excluded from taxation by a given state. Taxable dividends for example, that are considered nonbusiness income, whether domestic or foreign, are usually specifically allocated to the state of the taxpayer's commercial domicile. Rental income from real property is usually allocated to the state of the property's situs.

Section 302 of S. 983 provides that foreign source income received by a corporation may be neither apportioned nor allocated to any state. In addition to dividends, this prohibition would apply to interest, rents, royalties, license and technical fees, and gains from foreign sources. Thus, this bill contains a broad prohibition on the state taxation of foreign source income. In contrast, S. 1688 is addressed only to dividends. S. 1688 would limit state taxation of dividends received by corporations from foreign corporations by requiring that a specified amount of such dividends be excluded from the state tax base. States would be able to tax only the non-excluded portion. The excluded amount is specified for two classes of corporations: (1) domestic corporations (treated as foreign under the bill) whose dividend distributions are, pursuant to Code section 861(a)(2)(A), foreign source and (2) all foreign corporations. The domestic corporations treated as foreign under the bill are corporations which either

have an election in effect under section 936, or which have less than 20 percent of their gross income from United States sources.

The excluded portion of the dividend received from these domestic corporations is equal to the deduction allowed by section 243 of the Code or the amount excluded in determining the tax liability of an affiliated group of corporations in accordance with section 1502 of the Code. Section 243 permits a U.S. corporation to deduct 85 percent of dividends received from another U.S. corporation or 100 percent of qualifying dividends received from members of its affiliated group. Similarly, affiliated corporations, in accordance with section 1502, are entitled to a 100 percent dividend deduction. An affiliated group must be connected through at least 80 percent stock ownership. Thus, S. 1688 would exclude from the states' tax base either 85 percent or 100 percent of dividends received from these corporations.

With respect to dividends received from foreign corporations, the portion excluded by S. 1688 is equal to the greater of the section 78 "gross-up" or the proportion of the dividend, including the section 78 gross-up, that the foreign tax rate bears to the current 46 percent U.S. corporate tax rate. For purposes of the Federal foreign tax credit, section 78 of the Code requires that the underlying foreign corporate taxes on the earnings out of which foreign dividend income is paid be included in the gross income of the corporation receiving the dividend. In effect, dividends from a foreign corporation are increased by the amount of foreign taxes deemed paid by the recipient of the dividends and for which a foreign tax credit is claimed. By removing this gross-up from the tax base, the bill would prohibit states from including in their tax base amounts expended by foreign subsidiaries for foreign taxes.

This exclusion, however, will frequently be less than the alternative exclusion in S. 1688, the proportion of the total, grossed-up dividend that the foreign tax rate (both underlying corporate tax and dividend withholding tax) bears to the current 46 percent U.S. tax rate. Thus, if total foreign taxes also are 46 percent, the excluded portion of the dividend equals 100 percent, and the entire dividend would be excluded from the state tax base. If, instead, the foreign taxes were one-half the current U.S. rate, or

23 percent, one-half the dividend would be excluded from the state tax base.

The question of how states should treat foreign source income for tax purposes deserves far more attention and consideration than we have given it to date. Both S. 983 and S. 1688 would restrict state taxation of foreign source income. Is this the correct result? If so, why does S. 1688 apply to dividends, but not to interest, rents, royalties, and other categories of foreign income? Both bills apply to corporations; why are individuals and other taxpayers excluded? Because a multistate corporation pays both Federal and state income taxes on its operating income, limiting state taxation to U.S. source income may tilt the tax incentives toward foreign investment and employment. Is that appropriate?

Even if we conclude that states ought in principle to be able to tax foreign source income, should the Federal government nonetheless place some limits on that jurisdiction? What happens when two or more states, because of conflicting rules of corporate taxation, assert the right to tax the same income? If states are taxing on the basis of domicile, and not just U.S. source, should they have an obligation to credit foreign taxes or otherwise eliminate international double taxation? S.1688 provides for a partial (or in some cases a total) exclusion of foreign source dividends from taxable income for state tax purposes. But in many cases that formula goes well beyond eliminating double taxation and the formula's underlying rationale is unclear. Perhaps the states should, like the Federal government, allow a credit for foreign taxes paid or deemed paid by the U.S. recipient. That approach would, however, require coordination of foreign tax credits among the state and Federal governments, which may be complex and create other problems.

In short, the issues raised by limitations on state taxation of foreign source income are far more complex and their appropriate resolution far less certain than the unitary apportionment issue for foreign corporations. Because it is critical that we resolve the unitary apportionment problem expeditiously, we favor going forward now with the unitary portion of the bills before us, but holding the foreign income issues over for further consideration.

EXHIBIT 46F

Department of the Treasury NEWS
Washington, D.C. 20220 Telephone 566-2041

FOR RELEASE UPON DELIVERY
10:00 a.m. (E.D.T.)
March 31, 1980

STATEMENT OF THE HONORABLE
DONALD C. LUBICK
ASSISTANT SECRETARY OF THE TREASURY
FOR TAX POLICY
BEFORE THE HOUSE
WAYS AND MEANS COMMITTEE
ON H.R. 5076

Mr. Chairman and members of this Committee:

I am pleased to have the opportunity to appear today to present the views of the Treasury Department on H.R. 5076 which would clarify the extent to which a state, or political subdivision, may take account of certain income from sources outside the United States in imposing its income taxes.

H.R. 5076 has two distinct parts, one dealing with state unitary apportionment taxation systems as applied to foreign corporations and the other dealing with state taxation of dividends received by a corporation from a foreign corporation.

Under unitary apportionment systems as applied in several states, the income of a corporation doing business in the state is determined for state income tax purposes by applying a formula taking account of the income, payroll, property, and sales of the corporation subject to tax and all related corporations which are considered part of a unitary business (i.e., whose activities are dependent upon or contribute to the business of the corporation whose income is being taxed). No distinction is made, in some states, between U.S. and foreign corporations or between corporate groups controlled by U.S. corporations and those controlled by foreign corporations. The first part of H.R. 5076 is aimed at

the practice of including foreign corporations in the unitary apportionment system.

This practice creates three types of problems: (1) It can result in a determination of income for state tax purposes which is substantially different than the income which would be attributed to the corporation doing business in the state if an arm's-length or separate accounting method were used. To the extent that the relationship between the three apportionment factors (payroll, property, and sales) and the income to be apportioned differs markedly in foreign countries from the relationship which generally applies within the United States, the measurement of income by this method can result in serious distortions. In practice, the unitary apportionment system appears in comparison to an arm's length or separate accounting method to generate substantially more taxes for the states. (2) The practice can impose a substantial administrative burden, involving annual translation of the books of what may be a substantial number of foreign corporations into U.S. accounting concepts and U.S. currency. (3) The practice has created, and continues to create, an irritant in the international relations of the United States. A number of foreign governments have complained, both officially and informally, that the unitary system differs from the arm's-length method used by the Federal Government and generally accepted in international practice.

The first part of the bill, reflected in paragraphs (a) through (d) of a proposed new section 7518 of the Internal Revenue Code, would prohibit any state or political subdivision, in imposing tax on any corporation, from taking into account in its unitary apportionment formulas the income of any foreign corporation which is a member of an affiliated group including the foreign corporation and the corporation subject to tax, unless the income of 'the corporation' (presumably the foreign corporation) is subject to Federal income tax.

Although the bill makes no distinction between corporate groups under United States control and those under foreign control, such a distinction may be warranted. Of the three types of problems created by the international application of unitary apportionment, only the first--the potential for a distorted mea-

surement of taxable income--applies fully with respect to U.S. based multinational groups. U.S. parent corporations are already required to submit financial statements to the IRS annually with respect to their overseas subsidiaries. Thus, the administrative burdens which the unitary system creates for foreign based corporate groups are not present to the same degree for a group controlled from the United States. Similarly, the application of a unitary system to U.S. controlled corporate groups represents much less of an international irritant, if in fact that problem is present at all.

The Treasury Department supports the goals of paragraph (a) of the bill, with respect to affiliated groups controlled by foreign persons. We do not oppose the provisions of paragraph (a) of the bill insofar as U.S. controlled corporate groups are concerned.

There are, however, several technical problems in paragraphs (a) through (d) of the proposed section 7518 which should be addressed. We have pointed these problems out in a written submission to the Chairman and would, of course, be pleased to work with the staff in any further drafting that is undertaken.

The second part of H.R. 5076, paragraph (e) of proposed Code section 7518, would restrict state taxation of foreign-source dividends received by corporations. Forty-six states, including the District of Columbia, levy taxes with respect to corporate income; these taxes are either denominated as income taxes or as excise or franchise taxes measured by income. Only a few states have special rules for the taxation of foreign source income, that is, income from sources outside the United States. In most cases, the treatment of foreign source dividend income derives from the general rules for taxing a corporation. Dividends received by corporations from foreign sources are generally excluded from the tax base in about one-third of the states and generally included in the tax base in about two-thirds of the states.

Taxable dividends, whether of domestic or foreign source, usually are apportioned by formula if they are considered business income. Formula apportionment is a method for dividing the tax base among the states, in which the share to be assigned to a particular state is determined by reference to one or more ratios in

which economic values or activities within the state are compared with the taxpayer's total activities or values of the same kind everywhere. States differ in how they define business income. Some presumptively consider nearly all income to be business income. Others define business income less broadly by following the definition of business income in the Uniform Division of Income for Tax Purposes Act. It is:

> ...income arising from transactions and activity in the regular course of the taxpayer's trade or business ... (including) income from tangible and intangible property if the acquisition, management and disposition of the property constitute integral parts of the taxpayer's regular trade or business operations.

Under this narrower definition of business income, most dividends would be considered nonbusiness income and would be specifically allocated.

Allocation means the attribution of an income item to a specific geographic category; the particular income is thus attributed wholly to a given state, or is wholly excluded from taxation by a given state. Taxable dividends that are considered nonbusiness income, whether domestic or foreign, are usually specifically allocated to the state of the taxpayer's commercial domicile.

The bill would limit state taxation of dividends received by corporations from foreign corporations by requiring that a specified amount of such dividends be excluded from the state tax base. States would be able to tax only the non-excluded portion. The excluded amount is specified for two classes of corporations: (1) domestic corporations (treated as foreign under the bill) whose dividend distributions are, pursuant to Code section 861(a)(2)(A), foreign source and (2) all foreign corporations. Domestic corporations described in section 861(a)(2)(A) are corporations which either have an election in effect under section 936, or which have less than 20 percent of their gross income from United States sources.

The excluded portion of the dividend received from domestic corporations described in section 861(a)(2)(A) is equal to the deduction allowed by section 243 of the Code or the amount excluded in determining the tax liability of an affiliated group of

corporations in accordance with section 1502 of the Code. Section 243 permits a U.S. corporation to deduct 85 percent of dividends received from another U.S. corporation or 100 percent of qualifying dividends received from members of its affiliated group. Similarly, affiliated corporations, in accordance with section 1502, are entitled to a 100 percent dividend deduction. An affiliated group must be connected through at least 80 percent stock ownership. Thus, the bill would exclude from state tax bases either 85 percent or 100 percent of dividends received from corporations with less than 20 percent U.S. source income.

With respect to dividends received from foreign corporations, the excluded portion is equal to the greater of the section 78 "gross-up" or the proportion of the dividend, including the section 78 gross-up, that the foreign tax rate bears to the current 46 percent U.S. corporate tax rate. For purposes of the Federal foreign tax credit, section 78 of the Code requires that the underlying foreign corporate taxes on the earnings out of which foreign dividend income is paid be included in the gross income of the corporation receiving the dividend. In effect, dividends from a foreign corporation are increased by the amount of foreign taxes deemed paid by the recipient of the dividends and for which a foreign tax credit is claimed. By removing this gross-up from the tax base, the bill would prohibit states from including in their tax base amounts expended by foreign subsidiaries for foreign taxes. This exclusion, however, will frequently be less than the alternative exclusion in the bill, the proportion of the total, grossed-up dividend that the foreign tax rate (both underlying corporate tax and dividend withholding tax) bears to the current 46 percent U.S. tax rate. Thus, if total foreign taxes also are 46 percent, the excluded portion of the dividend equals 100 percent, and the entire dividend would be excluded from the state tax base. If, instead, the foreign taxes were one-half the current U.S. rate, or 23 percent, one-half the dividend would be excluded from the state tax base.

The Treasury Department has no objection to requiring that the section 78 "gross-up" be excluded from the state tax base. This would merely require a state to allow an exclusion or deduction for foreign taxes. Although many states already allow

this, it seems reasonable to require all states to recognize foreign taxes as a legitimate business deduction.

The treatment of dividends provided by the remaining provisions of the bill might, however, unintentionally favor foreign over United States investment. Many, but not all, states follow the Federal practice of allowing a general deduction for intercorporate dividends from essentially domestic corporations. Consequently, the exclusion for dividends from foreign corporations provided by this bill might be viewed as placing foreign dividends on an equal tax footing with domestic dividends.

But this overlooks the fact that a multistate corporation pays both Federal and state income taxes on its operating income. The dividends received deduction is intended to prevent the taxation of income that already has borne tax at both the Federal and state levels. Neither Federal nor state income tax is paid, however, on the income of a foreign corporation, until that income is repatriated as a dividend to the domestic corporate shareholder. To the extent this bill excludes these dividends from the state tax base, it eliminates the state level of taxation. Accordingly, multinational operations would be taxed more favorably than multistate operations.

The Treasury Department believes that it is undesirable to create a tax preference for foreign investment. While this is Treasury's primary objection to the second portion of the bill, there are other troublesome aspects. It is unclear why individuals and other taxpayers have been excluded. Similarly, since the bill applies only to dividends, it would favor corporate taxpayers receiving dividends over those receiving rent, interest, and royalty payments. Finally, the bill is geared to the current maximum U.S. corporate rate of 46 percent, rather than the maximum rate in effect at any particular time.

For these reasons, the Treasury opposes the provisions of H.R. 5076 relating to state taxation of foreign-source dividends.

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EXHIBIT 46H

United States Department of State
Washington, D.C. 20520

February 7, 1986

To Whom It May Concern:

I, Frank M. Machak, certify that I am the Acting Director, Foreign Affairs Information Management Center (FAIM) of the United States Department of State. In this capacity, I am the custodian of the official records of the Department of State.

I certify that the document hereunto annexed is a true copy of a document retrieved from the files of the Department of State:

Letter from Secretary of State George P. Shultz to Governor Deukmejian, dated January 30, 1986.

FRANK M. MACHAK
Frank M. Machak
Acting Director
Foreign Affairs Information
Management Center

THE SECRETARY OF STATE
WASHINGTON

January 30, 1986

Dear Governor Deukmejian:

As you are aware, federal legislation was recently introduced with the full support of the Administration which would prohibit states from taxing corporations under the worldwide unitary method and from taxing more than an equitable share of foreign source dividends. This action was taken at the express direction of the President. I am writing to explain to you the foreign policy concerns that prompted this legislation and to urge you to act promptly to reconsider your state's use of the worldwide unitary method of taxation.

When a corporation (or related group of corporations) operates across state or national boundaries, competing tax claims of the jurisdictions in which the corporate group operates are resolved by identifying the income attributable to each jurisdiction. Two different methods are in use for making the determination with respect to transnational income: separate accounting and worldwide unitary combination. The longstanding policy of the federal government has been to follow the separate accounting method. The United States has advocated and adopted the position that the "arm's-length" adjustment method of allocating income among commonly controlled corporations doing business in various national jurisdictions is the appropriate method to be employed. This view is embodied in the Internal Revenue Code and is a central feature in our bilateral tax treaties. Separate accounting is also the international standard. It is prescribed in the model income tax treaties published by the Organization for Economic Cooperation and Development ("OECD") and the United Nations ("UN") and by foreign country tax systems generally. In contrast, the worldwide unitary method of taxation is followed only by seven of the U.S. states. Your state's employment of the worldwide unitary method of tax accounting is at odds with the position of the United States and has become a source of conflict with foreign states.

The Honorable
George Deukmejian,
Governor of California,
Sacramento.

In an environment in which separate accounting is the federal policy and the generally accepted international rule, state taxation on a worldwide unitary basis creates a clear risk of double taxation. Because labor costs and property values vary sharply on an international basis, the rates of profitability of affiliates operating within and without the jurisdiction of the unitary state are often different. Double taxation will result if the relative profitability of the investment in the unitary tax state is less than that of the affiliated overseas operations that are taxed abroad on a separate accounting basis. This risk of double taxation may distort investment decisions, thereby reducing the overall flow of investment into the United States.

Our concern over the worldwide unitary method of taxation's inhibiting effect on foreign investment in the United States is shared by many foreign governments. They have advised us of their view that "The [unitary tax] method can chill international investment and decrease efficient allocation of resources and employment opportunities. In particular, the unitary method can impede foreign entry into the United States market." They contend that the unitary method of taxation constitutes " . . . a serious obstacle to the further development of our trade and investment relationships." (Diplomatic note signed by the Ambassadors of Australia, Belgium, Canada, Denmark, France, Federal Republic of Germany, the United Kingdom, Greece, Ireland, Italy, Japan, Luxembourg, the Netherlands, and Switzerland.)

The administration of the worldwide unitary method of taxation also imposes unreasonable and costly compliance burdens on an enterprise which is considered to be part of a worldwide unitary group. The information required by the tax authorities of the jurisdiction practicing a worldwide unitary method of taxation may not be readily available to the enterprise and, in the case of foreign-controlled entities which are not required to keep data under U.S. tax and financial accounting rules on their non-U.S. operations for any other reason, will require costly conversion into a form usable by the jurisdiction's tax authority.

For these reasons I believe state worldwide unitary taxation to be inappropriate. Continued state taxation on a worldwide unitary basis will greatly impair the ability of the federal government to

carry out its tax and investment policy in the international arena and to manage the sensitive issue of international double taxation. The worldwide unitary issue has seriously complicated our economic relations with many of our closest allies. During my tenure as Secretary of State, this has been a difficult and long-lasting issue. The Department of State has received diplomatic notes complaining about state use of the worldwide unitary method of taxation from virtually every developed country in the world. The unitary issue has been partially responsible for stalling some bilateral tax treaty negotiations.

Most seriously, the U.K. Parliament, in July, 1985, unanimously adopted anti-unitary retaliatory legislation permitting the U.K. government to deny, on a unilateral basis and retroactive to April, 1985, a very valuable benefit of the U.S.-U.K. tax treaty for U.S. corporations operating in worldwide unitary states. This legislation, by virtue of a provision which makes possible the retroactive imposition of heavy penalties, was having a chilling effect on the willingness of U.S. companies to repatriate earnings of their U.K. subsidiaries to the United States and on their willingness to claim benefits properly available to them under the treaty. While the U.K. has agreed to defer implementation of this legislation for the time being, this incident makes it clear that state worldwide unitary taxation is adversely affecting the United States' foreign economic relations.

While the Administration has proposed federal legislation prohibiting worldwide unitary taxation and limiting state taxation of foreign dividends, I would welcome swift legislative or administrative action by your state to terminate your state's use of the worldwide unitary method of taxation and to limit appropriately your state's taxation of foreign source dividends.

Sincerely yours,

George P. Shultz

EXHIBIT 53

Department of International Economic and Social Affairs

UNITED NATIONS
MODEL DOUBLE TAXATION CONVENTION BETWEEN DEVELOPED AND DEVELOPING COUNTRIES

UNITED NATIONS
NEW YORK, 1980

NOTE

Symbols of United Nations documents are composed of capital letters combined with figures. Mention of such a symbol indicates a reference to a United Nations document.

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* * *

[p. 19] Chapter I

SCOPE OF THE CONVENTION

* * *

Article 2

TAXES COVERED

1. This Convention shall apply to taxes on income [and on capital] imposed on behalf of a Contracting State or of its political subdivisions or local authorities, irrespective of the manner in which they are levied.

2. There shall be regarded as taxes on income [and on capital] all taxes imposed on total income, [on total capital,] or on elements of income [or of capital,] including taxes on gains from the alienation of movable or immovable property, taxes on the total amounts of wages or salaries paid by enterprises, as well as taxes on capital appreciation.

3. The existing taxes to which the Convention shall apply are in particular:

(*a*) (in State A):...................................

(*b*) (in State B):...................................

4. The Convention shall apply also to any identical or substantially similar taxes which are imposed after the date of signature of the Convention in addition to, or in place of, the existing taxes. At the end of each year, the competent authorities of the Contracting States shall notify each other of changes which have been made in their respective taxation laws.

* * *

[p. 20] Chapter II

DEFINITIONS

* * *

[p. 21] *Article 5*

PERMANENT ESTABLISHMENT

1. For the purposes of this Convention, the term "permanent establishment" means a fixed place of business through which the business of an enterprise is wholly or partly carried on.

2. The term "permanent establishment" includes especially:

(a) A place of management;

(b) A branch;

(c) An office;

(d) A factory;

(e) A workshop;

(f) A mine, an oil or gas well, a quarry or any other place of extraction of natural resources.

3. The term "permanent establishment" likewise encompasses:

(a) A building site, a construction, assembly or installation project or supervisory activities in connexion therewith, but only where such site, project or activities continue for a period of more than six months;

(b) The furnishing of services, including consultancy services, by an enterprise through employees or other personnel engaged by the enterprise for such purpose, but only where activities of that nature continue (for the same or a connected project) within the country for a period or periods aggregating more than six months within any 12-month period.

[p. 22] 4. Notwithstanding the preceding provisions of this article, the term "permanent establishment" shall be deemed not to include:

(a) The use of facilities solely for the purpose of storage or display of goods or merchandise belonging to the enterprise;

(b) The maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of storage or display;

(c) The maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of processing by another enterprise;

(d) The maintenance of a fixed place of business solely for the purpose of purchasing goods or merchandise or of collecting information, for the enterprise;

(e) The maintenance of a fixed place of business solely for the purpose of carrying on, for the enterprise, any other activity of a preparatory or auxiliary character.

5. Notwithstanding the provisions of paragraphs 1 and 2, where a person — other than an agent of an independent status to whom paragraph 7 applies — is acting in a Contracting State on behalf of an enterprise of the other Contracting State, that enterprise shall be deemed to have a permanent establishment in the first-mentioned Contracting State in respect of any activities which that person undertakes for the enterprise, if such a person:

(a) Has and habitually exercises in that State an authority to conclude contracts in the name of the enterprise, unless the activities of such person are limited to those mentioned in paragraph 4 which, if exercised through a fixed place of business, would not make this fixed place of business a permanent establishment under the provisions of that paragraph; or

(b) Has no such authority, but habitually maintains in the first-mentioned State a stock of goods or merchandise from which he regularly delivers goods or merchandise on behalf of the enterprise.

6. Notwithstanding the preceding provisions of this article, an insurance enterprise of Contracting State shall, except in regard to re-insurance, be deemed to have a permanent establishment in the other Contracting State if it collects premiums in the territory

of that other State or insures risks situated therein through a person other than an agent of an independent status to whom paragraph 7 applies.

7. An enterprise of a Contracting State shall not be deemed to have a permanent establishment in the other Contracting State merely because it carries on business in that other State through a broker, general commission agent or any other agent of an independent status, provided that such persons are acting in the ordinary course of their business. However, when the activities of such an agent are devoted wholly or almost wholly on behalf of that enterprise, he will [p. 23] not be considered an agent of an independent status within the meaning of this paragraph.

8. The fact that a company which is a resident of a Contracting State controls or is controlled by a company which is a resident of the other Contracting State, or which carries on business in that other State (whether through a permanent establishment or otherwise) shall not of itself constitute either company a permanent establishment of the other.

[p. 24] Chapter III

TAXATION OF INCOME

* * *

Article 7

Business profits

1. The profits of an enterprise of a Contracting State shall be taxable only in that State unless the enterprise carries on business in the other Contracting State through a permanent establishment situated therein. If the enterprise carries on business as aforesaid, the profits of the enterprise may be taxed in the other State but only so much of them as is attributable to (*a*) that permanent establishment; (*b*) sales in that other State of goods or merchandise of the same or similar kind as those sold through that permanent establishment; or (*c*) other business activities

carried on in that other State of the same or similar kind as those effected through that permanent establishment.

[p. 25] 2. Subject to the provisions of paragraph 3, where an enterprise of a Contracting State carries on business in the other Contracting State through a permanent establishment situated therein, there shall in each Contracting State be attributed to that permanent establishment the profits which it might be expected to make if it were a distinct and separate enterprise engaged in the same or similar activities under the same or similar conditions and dealing wholly independently with the enterprise of which it is a permanent establishment.

3. In the determination of the profits of a permanent establishment, there shall be allowed as deductions expenses which are incurred for the purposes of the business of the permanent establishment including executive and general administrative expenses so incurred, whether in the State in which the permanent establishment is situated or elsewhere. However, no such deduction shall be allowed in respect of amounts, if any, paid (otherwise than towards reimbursement of actual expenses) by the permanent establishment to the head office of the enterprise or any of its other offices, by way of royalties, fees or other similar payments in return for the use of patents or other rights, or by way of commission, for specific services performed or for management, or, except in the case of a banking enterprise, by way of interest on moneys lent to the permanent establishment. Likewise, no account shall be taken, in the determination of the profits of a permanent establishment, for amounts charged (otherwise than towards reimbursement of actual expenses), by the permanent establishment to the head office of the enterprise or any of its other offices, by way of royalties, fees or other similar payments in return for the use of patents or other rights, or by way of commission for specific services performed or for management, or, except in the case of a banking enterprise by way of interest on moneys lent to the head office of the enterprise or any of its other offices.

4. In so far as it has been customary in a Contracting State to determine the profits to be attributed to a permanent establishment on the basis of an apportionment of the total profits of the

enterprise to its various parts, nothing in paragraph 2 shall preclude that Contracting State from determining the profits to be taxed by such an apportionment as may be customary; the method of apportionment adopted shall, however, be such that the result shall be in accordance with the principles contained in this article.

5. For the purposes of the preceding paragraphs, the profits to be attributed to the permanent establishment shall be determined by the same method year by year unless there is good and sufficient reason to the contrary.

6. Where profits include items of income which are dealt with separately in other articles of this Convention, then the provisions of those articles shall not be affected by the provisions of this article.

> (NOTE: the question of whether profits should be attributed [p. 26] to a permanent establishment by reason of the mere purchase by that permanent establishment of goods and merchandise for the enterprise was not resolved. It should therefore be settled in bilateral negotiations.)

* * *

[p. 27] *Article 9*

ASSOCIATED ENTERPRISES

1. Where:

(*a*) An enterprise of a Contracting State participates directly or indirectly in the management, control or capital of an enterprise of the other Contracting State, or

(*b*) The same persons participate directly or indirectly in the management, control or capital of an enterprise of a Contracting State and an enterprise of the other Contracting State,

and in either case conditions are made or imposed between the two enterprises in their commercial or financial relations which differ from those which would be made between independent enterprises, then any profits which would, but for those conditions, have not so accrued, may be included in the profits of that enterprise and taxed accordingly.

2. Where a Contracting State includes in the profits of an enterprise of that State — and taxes accordingly — profits on which an enterprise of the other Contracting State has been charged to tax in that other State and the profits so included are profits which would have accrued to the enterprise of the first-mentioned State if the conditions made between the two enterprises had been those which would have been made between independent enterprises, then that other State shall make an appropriate adjustment to the amount of the tax charged therein on those profits. In determining such adjustment, due regard shall be had to the other provisions of the Convention and the competent authorities of the Contracting States shall, if necessary, consult each other.

* * *

[p. 39] Chapter VI

SPECIAL PROVISIONS

Article 24

Non-Discrimination

1. Nationals of a Contracting State shall not be subjected in the other Contracting State to any taxation or any requirement connected therewith which is other or more burdensome than the taxation and connected requirements to which nationals of that other State in the same circumstances are or may be subjected. This provision shall, notwithstanding the provisions of article 1, also apply to persons who are not residents of one or both of the Contracting States.

2. The term "nationals" means:

(*a*) All individuals possessing the nationality of a Contracting State;

(*b*) All legal persons, partnerships and associations deriving their status as such from the laws in force in a Contracting State.

3. Stateless persons who are residents of a Contracting State shall not be subjected in either Contracting State to any taxation or any requirement connected therewith which is other or more burdensome than the taxation and connected requirements to which nationals of the State concerned in the same circumstances are or may be subjected.

4. The taxation on a permanent establishment which an enterprise of a Contracting State has in the other Contracting State shall not be less favourably levied in that other State than the taxaton levied on enterprises of that other State carrying on the same activities. This provision shall not be construed as obliging a Contracting State to grant to residents of the other Contracting State any personal allowances, reliefs and reductions for taxation purposes on account of civil status or family responsibilities which it grants to its own residents.

5. Except where the provisions of paragraph 1 of article 9, paragraph 6 of article 11, or paragraph 6 of article 12 apply, interest, royalties and other disbursements paid by an enterprise of a Contracting State to a resident of the other Contracting State shall, for the purpose of determining the taxable profits of such enterprise, be deductible under the same conditions as if they had been paid to a resident of the first-mentioned State. [Similarly, any debts of an enterprise of a Contracting State to a resident of the other Contracting State shall, for the purpose of determining the taxable capital of such [p. 40] enterprise, be deductible under the same conditions as if they had been contracted to a resident of the first-mentioned State.]

6. Enterprises of a Contracting State, the capital of which is wholly or partly owned or controlled, directly or indirectly, by one or more residents of the other Contracting State, shall not be subjected in the first-mentioned State to any taxation or any requirement connected therewith which is other or more burdensome than the taxation and connected requirements to which other similar enterprises of the first-mentioned State are or may be subjected.

7. The provisions of this article shall, notwithstanding the provisions of article 2, apply to taxes of every kind and description.

* * *

[p. 43] *Part Two*

Commentaries on the Articles of the United Nations Model Double Taxation Convention between Developed and Developing Countries

* * *

[p. 47] *Article 2*

Taxes covered by the Convention

A. General considerations

Article 2 of the United Nations Model Convention reproduces article 2 of the OECD Model Convention.

This article is designed to clarify and render more precise the terminology and nomenclature concerning the taxes to be covered by the convention. In this connexion, it may be observed that the same income or capital may be subject in the same country to various taxes — either taxes which differ in nature or taxes of the same nature levied by different political subdivisions or local authorities. Hence double taxation cannot be wholly avoided unless the methods for the relief of double taxation applied in each Contracting State take into account all the taxes to which such income or capital is subject. Consequently, the terminology and nomenclature relating to the taxes covered by a treaty must be clear, precise and as comprehensive as possible. As noted in the OECD commentary on article 2 of the OECD Model Convention, this is necessary:

"to ensure identification of the Contracting States' taxes covered by the Convention, to widen as much as possible the field of application of the Convention by including, as far as possible, and in harmony with the domestic laws of the Contracting States, the taxes imposed by their political subdivisions

or local authorities, and to avoid the necessity of concluding a new convention whenever the Contracting States' domestic laws are modified, by means of the periodical exchange of lists and through a procedure for mutual consultation".

B. COMMENTARY ON THE PARAGRAPHS OF ARTICLE 2

Paragraph 1

This paragraph indicates that the scope of application of the Convention should encompass taxes on income and on capital, irrespective of the authority on behalf of which such taxes are imposed (e.g., the State itself or its political subdivisions or local authorities) and irrespective of the method by which the taxes are levied (e.g., by direct assessment or by deduction at the source, in the form of surtaxes or surcharges or as additional taxes).

Paragraph 2

This paragraph contains a definition of taxes on income and on capital, which include all taxes on total income, on total capital or on elements of income or of capital, including taxes on gains from the alienation of movable or immovable property, taxes on capital appreciation [p. 48] and taxes on the total amounts of wages or salaries paid by enterprises. According to the commentary on article 2, paragraph 2, of the OECD Model Convention, the last-named taxes do not include "social security charges or any other charges paid where there is a direct connexion between the levy and the individual benefits to be received". The OECD commentary further observes:

"Clearly a State possessing taxing powers — and it alone — may levy the taxes imposed by its legislation together with any duties or charges accessory to them: increases, costs, interest, etc. It has not been considered necessary to specify this in the Article, as it is obvious that in the levying of the tax the accessory duties or charges depend on the same rule as the principal duty.

"The Article does not mention 'ordinary taxes' or 'extraordinary taxes'. Normally, it might be considered justifiable to include extraordinary taxes in a Model Convention, but experience has shown that such taxes are generally imposed in very special circumstances. In addition, it would be difficult to define them. These may be extraordinary for various reasons; their imposition, the manner in which they are levied, their rates, their objects, etc. This being so, it seems preferable not to include extraordinary taxes in the Article. But as it is not intended to exclude extraordinary taxes from all conventions, ordinary taxes have not been mentioned either. The Contracting States are thus free to restrict the convention's field of application to ordinary taxes, to extend it to extraordinary taxes, or even to establish special provisions."

Paragraph 3

This paragraph provides the Contracting States with an opportunity to enumerate the taxes to which the convention is to apply. According to the commentary on article 2, paragraph 3, of the OECD Model Convention, the list "is not exhaustive", for "it serves to illustrate the preceding paragraphs of the article". In principle, however, it is expected to be "a complete list of taxes imposed in each State at the time of signature and covered by the convention".

Paragraph 4

This paragraph supplements paragraph 3 by stating that the Convention is to apply also to any identical or substantially similar taxes which are imposed after the date of signature of the convention in addition to, or in place of, the existing taxes. According to the commentary on article 2, paragraph 4, of the OECD Model Convention, "this provision is necessary to prevent the Convention from becoming inoperative in the event of one of the States modifying its [p. 49] taxation laws". The commentary also notes that "each State undertakes to notify the other of any amendments made to its taxation laws by communicating to it at the end of each year, when necessary, a list of new or substituted taxes, imposed during that year". However, the competent authorities will have to work out the methods for applying para-

graph 4. In some cases countries may choose not to notify each other each year but only when substantive changes are made.

C. OBSERVATION ON THE OECD COMMENTARY AND RESERVATIONS ON ARTICLE 2 OF THE OECD MODEL CONVENTION

Observation on the commentary

"In contexts such as limitations on the rate of tax or the granting of credits for foreign tax, *New Zealand* would wish to make it clear that the term 'tax' does not include penalties."

Reservations on the article

"*Australia, Canada* and the *United States* reserve their positions on that part of paragraph 1 which states that the Convention should apply to taxes of political subdivisions or local authorities.

"*Japan* reserves its position on that part of paragraph 1 which states that the Convention shall apply to taxes on capital."

* * *

[p. 58] Article 5

PERMANANT ESTABLISHMENT

A. GENERAL CONSIDERATIONS

Article 5 of the United Nations Model Convention incorporates a number of provisions of article 5 of the OECD Model Convention (either unchanged or substantially amended) and some new provisions (details on the amendments and new provisions are provided below in the commentary on the paragraphs of the article).

The concept of permanent establishment is used in bilateral tax treaties principally for the purpose of determining the right of a Contracting State to tax the profits of an enterprise of the other Contracting State. According to that concept, an enterprise of one Contracting State is taxable in the other only if it maintains a

permanent establishment in the latter State and only to the extent that the profits earned by the enterprise in that State are attributable to the permanant establishment. The concept of permanent establishment is to be found in the early model conventions including the 1928 model Conventions of the League of Nations. The OECD Model Convention reaffirms the concept and supplements it by introducing the new concept of a "fixed base", to be used in the case of professional services or other activities of an independent character.

B. COMMENTARY ON THE PARAGRAPH OF ARTICLE 5

Paragraph 1

This paragraph, which reproduces article 5, paragraph 1, of the OECD Model Convention, provides a definition of the term "permanent establishment" which emphasized its essential nature as a "fixed place of business" with a specific "situs". According to the commentary [p. 59] on article 5, paragraph 1, of the OECD Model Convention, this definition contains the following conditions:

"— the existence of a 'place of business', i.e. a facility such as premises or, in certain instances, machinery or equipment;

"— this place of business must be 'fixed', i.e. it must be established at a distinct place with a certain degree of permanence;

"— the carrying on of the business of the enterprise through this fixed place of business. This means usually that persons who, in one way or another, are dependent on the enterprise (personnel) conduct the business of the enterprise in the State in which the fixed place is situated."

The OECD commentary goes on to observe:

"It could perhaps be argued that in the general definition some mention should also be made of the other characteristic of a permanent establishment to which some importance has sometimes been attached in the past, namely that the establish-

ment must have a productive character — i.e. contribute to the profits of the enterprise. In the present definition this course has not been taken. Within the framework of a well-run business organization it is surely axiomatic to assume that each part contributes to the productivity of the whole. It does not, of course, follow in every case that because in the wider context of the whole organisation a particular establishment has 'a productive character' it is consequently a permanent establishment to which profits can properly be attributed for the purpose of tax in a particular territory.

"The term 'place of business' covers any premises, facilities or installations used for carrying on the business of the enterprise whether or not they are used exclusively for that purpose. A place of business may also exist where no premises are available or required for carrying on the business of the enterprise and it simply has a certain amount of space at its disposal. It is immaterial whether the premises, facilities or installations are owned or rented by or are otherwise at the disposal of the enterprise. A place of business may thus be constituted by a pitch in a market place, or by a certain permanently used area in a Customs depot (e.g. for the storage of dutiable goods). Again the place of business may be situated in the business facilities of another enterprise. This may be the case, for instance where the foreign enterprise has at its constant disposal certain premises or a part thereof owned by the other enterprise.

"According to the definition, the place of business has to be a 'fixed' one. Thus in the normal way there has to be a link between the place of business and a specific geographical point. It is immaterial how long an enterprise of a Contracting State operates in the other Contracting State if it does not do so at a distinct [p. 60] place, but this does not mean that the equipment constituting the place of business has to be actually fixed to the soil on which it stands. It is enough that the equipment remains on a particular site.

"Since the place of business must be fixed, it also follows that a permanent establishment can be deemed to exist only if the place of business has a certain degree of permanency, i.e. if

it is not of a purely temporary nature. If the place of business was not set up merely for a temporary purpose, it can constitute a permanent establishment, even though it existed, in practice, only for a very short period of time because of the special nature of the activity of the enterprise or because, as a consequence of special circumstances (e.g. death of the taxpayer, investment failure), it was prematurely liquidated. Where a place of business which was, at the outset, designed for a short temporary purpose only, is maintained for such a period that it cannot be considered as a temporary one, it becomes a fixed place of business and thus — retrospectively — a permanent establishment.

"For a place of business to constitute a permanent establishment the enterprise using it must carry on its business wholly or partly through it. As stated in . . . above, the activity need not be of a productive character. Furthermore, the activity need not be permanent in the sense that there is no interruption of operation, but operations must be carried out on a regular basis.

"Where tangible property such as facilities, equipment, buildings, or intangible property such as patents, procedures and similar property, are let or leased to third parties through a fixed place of business maintained by an enterprise of a Contracting State in the other State, this activity will, in general, render the place of business a permanent establishment. The same applies if capital is made available through a fixed place of business. If an enterprise of a State lets or leases facilities, equipment, buildings or intangible property to an enterprise of the other State without maintaining for such letting or leasing activity a fixed place of business in the other State, the leased facility, equipment, building or intangible property, as such, will not constitute a permanent establishment of the lessor provided the contract is limited to the mere leasing of the equipment, etc. This remains the case even when, for example, the lessor supplies personnel after installation to operate the equipment provided that their responsibility is limited solely to the operation or maintenance of the equipment under the direction, responsibility and control of the lessee. If the personnel have wider responsibilities, for example participation in the

decisions regarding the work for which the equipment is used, the activity of the lessor may go beyond the mere leasing of equipment and may constitute an entrepreneurial [p. 61] activity. In such a case a permanent establishment could be deemed to exist if the criterion of permanency is met. When such activity is connected with, or is similar in character to, those mentioned in paragraph 3, the time limit of twelve months[1] applies. Other cases have to be determined according to the circumstances.

"The business of an enterprise is carried on mainly by the entrepreneur or persons who are in a paid-employment relationship with the enterprise (personnel). This personnel includes employees and other persons receiving instructions from the enterprise (e.g. dependent agents). The powers of such personnel in its relationship with third parties are irrelevant. It makes no difference whether or not the dependent agent is authorised to conclude contracts if he works at the fixed place of business. But a permanent establishment may nevertheless exist if the business of the enterprise is carried on mainly through automatic equipment, the activities of the personnel being restricted to setting up, operating, controlling and maintaining such equipment. Whether or not gaming and vending machines and the like set up by an enterprise of a State in the other State constitute a permanent establishment thus depends on whether or not the enterprise carries on a business activity besides the initial setting up of the machines. A permanent establishment does not exist if the enterprise merely sets up the machines and then leases the machines to other enterprises. A permanent establishment may exist, however, if the enterprise which sets up the machines also operates and maintains them for its own account. This also applies if the machines are operated and maintained by an agent dependent on the enterprise.

"A permanent establishment begins to exist as soon as the enterprise commences to carry on its business through a fixed place of business. This is the case once the enterprise prepares,

[1]Six months in the United Nations Model Convention.

at the place of business, the activity for which the place of business is to serve permanently. The period of time during which the fixed place of business itself is being set up by the enterprise should not be counted, provided that this activity differs substantially from the activity for which the place of business is to serve permanently. The permanent establishment ceases to exist with the disposal of the fixed place of business or with the cessation of any activity through it, that is when all acts and measures connected with the former activities of the permanent establishment are terminated (winding up current business transactions, maintenance and repair of facilities). A temporary [p. 62] interruption of operations, however, cannot be regarded as closure. If the fixed place of business is leased to another enterprise, it will normally only serve the activities of that enterprise instead of the lessor's; in general, the lessor's permanent establishment ceases to exist, except where he continues carrying on a business activity of his own through the fixed place of business."

Paragraph 2

Paragraph 2, which reproduces article 5, paragraph 2, of the OECD Model Convention, singles out a number of examples of what can be regarded, *prima facie,* as constituting a permanent establishment. During the discussion, a member from a developing country emphasized the need to broaden as much as possible the scope of the term "permanent establishment" and suggested that a warehouse should be included among the specific examples. However, it was agreed not to expand the list of examples in view of the fact that the deletion of the word "delivery" in subparagraphs (*a*) and (*b*) of paragraph 4 meant that a "warehouse" used for that purpose would constitute a permanent establishment. It was also noted that a "commercial warehouse", where for example space was being rented to other concerns, was covered as a permanent establishment. According to the commentary on article 5, paragraph 2, of the OECD Model Convention, it is assumed that the Contracting States interpret the terms listed "in such a way that such places of business constitute permanent establishments only if they meet the requirements of paragraph 1". With regard to the term "place of management",

the OECD commentary points out that it has been mentioned separately because it is not necessarily an "office" and that "where the laws of the two Contracting States do not contain the concept of a 'place of management' as distinct from an office, there will be no need to refer to the former term in their bilateral convention".

In connexion with subparagraph (*f*), which provides that the term "permanent establishment" includes mines, oil or gas wells, quarries or any other place of extraction of natural resources, the OECD commentary states that "the term 'any other place of extraction of natural resources' should be interpreted broadly" and that it includes, for example, all places of extraction of hydrocarbons whether on or off-shore. The OECD commentary further observes:

"Subparagraph (*f*) refers to the extraction of natural resources, but does not mention the exploration of such resources, whether on or off-shore. Therefore, whenever income from such activities is considered to be business profits, the question whether these activities are carried on through a permanent establishment is governed by paragraph 1. Since, however, it has not been possible to arrive at a common view on the basic questions of the attribution of taxation rights and of the qualification [p. 63] of the income from exploration activities, the Contracting States may agree upon the insertion of specific provisions. They may agree, for instance, that an enterprise of a Contracting State, as regards its activities of exploration of natural resources in a place or area in the other Contracting State:

"(*a*) shall be deemed not to have a permanent establishment in that other State; or

"(*b*) shall be deemed to carry on such activities through a permanent establishment in that other State; or

"(*c*) shall be deemed to carry on such activities through a permanent establishment in that other State if such activities last longer than a specified period to time.

The Contracting States may moreover agree to submit the income from such activities to any other rule."

Paragraph 3

This paragraph covers a broader range of activities than article 5, paragraph 3 of the OECD Model Convention. In subparagraph 3 (*a*), in addition to the term "installation project" used in the OECD Model Convention, there is included the term "assembly project" as well as "supervisory activities" in connection with "a building site, a construction, installation or assembly project". In the guidelines the term "assembly project" had been substituted for "installation project" but the group felt on reflection that it would best clarify the status of an installation project in this context if it was specifically mentioned in the paragraph. Another difference from the OECD Model Convention in this paragraph is that while the OECD Model Convention, in article 5, states that a "building site or construction or installation project constitutes a permanent establishment only if it lasts more than twelve months", article 5, paragraph 3, of the United Nations Model Convention reduces the duration of the relevant site or project to six months. In special cases the six-month period in paragraph 3, subparagraphs (*a*) and (*b*), of the latter article could be reduced in bilateral negotiations to a period of not less than three months.

It may be noted that there was substantial support within the group, especially among members from developing countries, for a more elaborate version of subparagraph 3 (*a*), which would have provided that the term "permanent establishment" should likewise encompass a situation:

"Where such project or activity, being incidental to the sale of machinery or equipment, continues for a period not exceeding six months and the charges payable for the project or activities exceed 10 per cent of the sale price of the machinery or equipment".

[p. 64] Other members, however, felt that such a provision would not constitute an adequate solution, particularly if the machinery was delivered by an enterprise other than the one doing the construction work.

Concerning the time-limit established in paragraph 3, subparagraphs *(a)* and *(b)*, of article 5 of the United Nations Model Convention, some members of the Group from developing countries said that they would have preferred to remove the time-limit altogether for two main reasons: first, because construction, assembly and similar activities could as a result of modern technology be of very short duration and still result in a considerable profit for the enterprise carrying on those activities; and secondly, because the period during which the foreign personnel involved in the activities remained in the source country was irrelevant to the definition of the right of developing countries to tax the corresponding income. Other members from developing countries felt that any time-limit should have been removed because such a limitation was apt to be used by enterprises of capital-exporting countries to evade taxation in the source country. The view was expressed that there was no reason why a construction project should not be treated in the same manner as artistes, athletes and public entertainers covered by article 17 of the OECD Model Convention, who are taxed at the place where their activities are performed irrespective of the duration of those activities. Members from developed countries observed that the Group's task was to work out guidelines for treaty provisions that would promote international trade and development, and that the idea behind the time-limit was that business enterprises of one Contracting State should be encouraged to initiate preparatory or ancillary operations in the other Contracting State without becoming immediately subject to the tax of the latter State, so as to facilitate a more permanent and larger commitment at a later stage.

Article 5, paragraph 3, of the United Nations Model Convention contains a new subparagraph *(b)* dealing with the furnishing of services, including consultancy services which are not covered specifically in the OECD Model Convention in connexion with the concept of permanent establishment. The Group felt that management and consultancy services should be covered because the provision of such services in developing countries by corporations of industrialized countries often involved very large sums of money. The Group was of the opinion that profits from such services should be taxed by developing countries in certain circumstances. However, some members from developing countries

proposed the inclusion in that paragraph of another criterion based on the amount of remuneration for the furnishing of services. Such criterion would constitute the subject of an additional sub-paragraph, namely subparagraph 3 *(c)*, which would be worded as follows:

> [p. 65] "*(c)* The furnishing of services including consultancy services by an enterprise, but only where the remuneration for activities of that nature (for the same or a connected project) derived from a resident of a Contracting State or a permanent establishment or a fixed base situated therein exceeds in the fiscal year an amount of . . . (an amount to be established through bilateral negotiations)".

Most members agreed that monetary limitations, if set by analogy with those applied to services of individuals in a number of tax treaties, would be meaningless in the area of the corporate services here discussed, while other members were opposed to any monetary limitations. On the other hand, some members felt that the physical presence of representatives of a foreign corporation in the source country for a minimum period, such as six months, would be a reasonable limitation which would, as a practical matter, cover most of the important situations and would preclude administrative difficulties in the case of merely sporadic activities. Some members preferred this paragraph without any limit on the amount of remuneration.

One member from a developed country expressed the view that the above provision might in certain cases have undesirable effects on international trade and on the transfer of technology.

Some members from developed countries thought that the time-limit approach would be an acceptable solution if the words "for the same or a connected project" were inserted after the word "continue", since they thought it desirable to add together unrelated projects in view of the uncertainty which that step involved and the undesirable distinction it created between an enterprise with, for example, one project of three months' duration and another with two projects, each of three months' duration, one following the other. In that respect, other members found that the injection of a "project" limitation would be either too easy to

manipulate or too narrow in that it might preclude taxation in the case of a continuous number of separate projects, each of four or five months' duration.

Some members from developing countries expressed the view that in bilateral negotiations a clause could be inserted in paragraph 3 which would stipulate that fishing ships pertaining to an enterprise of the Contracting State that operated in the territorial waters of the other Contracting State could be considered as permanent establishments in the latter State. In that sense they pointed out as an example that the establishment of a temporary limit on the amount of fish caught etc. would constitute an adequate means of solving the problem.

There was general agreement that only profits from service attributable to a permanent establishment in the source country should be taxable by it. In the context of this paragraph, the following [p. 66] passages of the commentary on article 5, paragraph 3, of the OECD Model Convention are relevant:

> "This paragraph provides expressly that a building site or construction or installation project constitutes a permanent establishment only if it lasts more than twelve months. Any of those items which does not meet this condition does not of itself constitute a permanent establishment, even if there is within it an installation, for instance an office or a workshop within the meaning of paragraph 2, associated with the construction activity.
>
> "The term 'building site or construction or installation project' includes not only the construction of buildings but also the construction of roads, bridges or canals, the laying of pipe-lines and excavating and dredging. Planning and supervision of the erection of a building are covered by this term, if carried out by the building contractor. However, planning and supervision is not included if carried out by another enterprise whose activities in connection with the construction concerned are restricted to planning and supervising the work. If that other enterprise has an office which it uses only for planning or supervision activities relating to a site or project which does not constitute a permanent establishment, such office does not constitute a fixed place of business within the meaning of paragraph 1, because its existence has not a certain degree of permanence.

> "The twelve month test applies to each individual site or project. In determining how long the site or project has existed, no account should be taken of the time previously spent by the contractor concerned on other sites or projects which are totally unconnected with it. A building site should be regarded as a single unit, even if it is based on several contracts, provided that it forms a coherent whole commercially and geographically. Subject to this proviso, a building site forms a single unit even if the orders have been placed by several persons (e.g. for a row of houses).
>
> "A site exists from the date on which the contractor begins his work, including any preparatory work, in the country where the construction is to be established, e.g. if he installs a planning office for the construction. In general, it continues to exist until the work is completed or permanently abandoned. A site should not be regarded as ceasing to exist when work is temporarily discontinued. Seasonal or other temporary interruptions should be included in determining the life of a site. Seasonal interruptions include interruptions due to bad weather. Temporary interruption could be caused, for example, by shortage of material or labour difficulties. Thus, for example, if a contractor started work on a road on 1st May, stopped on 1st November because of [p. 67] bad weather conditions or a lack of materials but resumed work on 1st February the following year, completing the road on 1st June, his construction project should be regarded as a permanent establishment because thirteen months elapsed between the date he first commenced work (1st May) and the date he finally finished (1st June of the following year). If an enterprise (general contractor) which has undertaken the performance of a comprehensive project sub-contracts parts of such a project to other enterprises (sub-contractors), the period spent by a sub-contractor working on the building site must be considered as being time spent by the general contractor on the building project.

The sub-contractor himself has a permanent establishment at the site if his activities there last more than twelve months.

"The very nature of a construction or installation project may be such that the contractor's activity has to be relocated continuously or at least from time to time, as the project progresses. This would be the case for instance where roads or canals were being constructed, waterways dredged, or pipelines laid. In such a case, the fact that the work force is not present for twelve months in one particular place is immaterial. The activities performed at each particular spot are part of a single project, and that project must be regarded as a permanent establishment if, as a whole, it lasts more than twelve months."

Paragraph 4

This paragraph reproduces article 5, paragraph 4 of the OECD Model Convention with three substantive amendments, namely the deletion of the term "delivery" in subparagraphs (*a*) and (*b*) and the deletion of subparagraph (*f*). The deletion of the word "delivery" means that a "warehouse" used for that purpose will constitute a permanent establishment. Furthermore, a "commercial warehouse", where space is rented to other concerns, is also a permanent establishment under paragraph 2.

The deletion of the term "delivery" was agreed on after members from developing countries pointed out that the presence of a stock of goods for prompt delivery facilitated the sales of the product and thereby the earning of profit in the host country by the enterprise having the facility. There was a continuous connexion and hence the existence of such a supply of goods, they argued, should constitute a permanent establishment, leaving as a separate matter the determination of the proper amount of income attributable to the permanent establishment. The Group felt that it would be preferable to leave open for bilateral negotiations the question of whether cases involving deliveries made from stocks of goods should be included in or excluded from the definition of permanent establishment. Some members [p. 68] from developed countries pointed out that since in the normal case only a small amount of income would be allocated if the only

activity were that described in the proposed clause, it would not serve any purpose to make the change.

Concerning paragraph 4, subparagraph (*f*), of the OECD Model Convention, although there was a general consensus not to include it in the United Nations Model Convention, some members of the Group indicated that the desirability of including it in a treaty could be left to bilateral negotiation. Subparagraph (*f*) of the OECD Model provides for: "the maintenance of a fixed place of business solely for any combination of activities mentioned in sub-paragraphs (*a*) to (*e*), provided that the overall activity of the fixed place of business resulting from this combination is of a preparatory or auxiliary character".

Concerning the business activities listed in paragraph 4, the commentary on article 5, paragraph 4, of the OECD Model Convention states that they are "treated as exceptions to the general definition laid down in paragraph 1" and that they "are not permanent establishments, even if the activity is carried on through a fixed place of business". The OECD commentary stresses that "the common feature of these activities is that they are in general preparatory or auxiliary activities" and that "the provisions of paragraph 4 are designed to prevent an enterprise of one State from being taxed in the other State, if it carries on in that other State activities of a purely preparatory or auxiliary character". The following passages of the OECD commentary are likewise relevant to article 5, paragraph 4, of the United Nations Model Convention.

"Subparagraph (*a*) relates only to the case in which an enterprise acquires the use of facilities for storing [or] displaying ..... its own goods or merchandise. Subparagraph (*b*) relates to the stock of merchandise itself and provides that the stock, as such, shall not be treated as a permanent establishment if it is maintained for the purpose of storage [or] display. Subparagraph (*c*) covers the case in which a stock of goods or merchandise belonging to one enterprise is processed by a second enterprise, on behalf of, or for the account of, the first-mentioned enterprise. The reference to the collection of information in subparagraph (*d*) is intended to include the case of the newspaper bureau which has no purpose other than to act

as one of many 'tentacles' of the parent body; to exempt such a bureau is to do no more than to extend the concept of 'mere purchase'.

"Subparagraph (*e*) provides that a fixed place of business through which the enterprise exercises solely an activity which has for the enterprise a preparatory or auxiliary character, is deemed not to be a permanent establishment. The wording of this subparagraph makes it unnecessary to produce an exhaustive list [p. 69] of exceptions. Furthermore, this sub-paragraph provides a generalized exception to the general definition in paragraph 1 and, when read with that paragraph, provides a more selective test, by which to determine what constitutes a permanent establishment. To a considerable degree it limits that definition and excludes from its rather wide scope a number of forms of business organizations which, although they are carried on through a fixed place of business, should not be treated as permanent establishments. It is recognized that such a place of business may well contribute to the productivity of the enterprise, but the services it performs are so remote from the actual realization of profits that it is difficult to allocate any profit to the fixed place of business solely for the purpose of advertising or for the supply of information or for scientific research or for the servicing of a patent or a know-how contract, if such activities have a preparatory or auxiliary character.

"It is often difficult to distinguish between activities which have a preparatory or auxiliary character and those which have not. The decisive criterion is whether or not the activity of the fixed place of business in itself forms an essential and significant part of the activity of the enterprise as a whole. Each individual case will have to be examined on its own merits. In any case, a fixed place of business whose general purpose is one which is identical to the general purpose of the whole enterprise, does not exercise a preparatory or auxiliary activity. Where, for example, the servicing of patents and know-how is the purpose of an enterprise, a fixed place of business of such enterprise exercising such an activity cannot get the benefits of subparagraph (*e*). A fixed place of business which has the

function of managing an enterprise or even only a part of an enterprise or of a group of the concern cannot be regarded as doing a preparatory or auxiliary activity, for such a managerial activity exceeds this level. If enterprises with international ramifications establish a so-called 'management office' in States in which they maintain subsidiaries, permanent establishments, agents or licensees, such office having supervisory and co-ordinating functions for all departments of the enterprise located within the region concerned, a permanent establishment will normally be deemed to exist, because the management office may be regarded as an office within the meaning of paragraph 2. Where a big international concern has delegated all management functions to its regional management offices so that the functions of the head office of the concern are restricted to general supervision (so-called polycentric enterprises), the regional management offices even have to be regarded as a 'place of management' within the meaning of subparagraph (*a*) of paragraph 2. The function of managing an enterprise, [p. 70] even if it only covers a certain area of the operations of the concern, constitutes an essential part of the business operations of the enterprise and therefore can in no way be regarded as an activity which has a preparatory or auxiliary character within the meaning of subparagraph (*e*) of paragraph 4.

"A permanent establishment could also be constituted if an enterprise maintains a fixed place of business in order to supply spare parts to customers for the machinery supplied to such customers, and to maintain and repair such machinery. Since these after-sale organisations perform an essential and significant part of the services of an enterprise vis-à-vis its customers, their activities are not merely auxiliary ones. Subparagraph (*e*) applies only if the activity of the fixed place of business is limited to a preparatory or auxiliary one. This would not be the case where, for example, the fixed place of business does not only give information but also furnishes plans etc. specially developed for the purposes of the individual customer. Nor would it be the case if a research establishment were to concern itself with manufacture.

"Moreover, subparagraph (*e*) makes it clear that the activities of the fixed place of business must be carried on for the enterprise. A fixed place of business which renders services not only to its enterprise but also directly to the other enterprises, for example to other companies of a group to which the company owning the fixed place belongs, would not fall within the scope of subparagraph (*e*).

". . .

"The fixed places of business mentioned in paragraph 4 cannot be deemed to constitute permanent establishments so long as their activities are restricted to the functions which are the prerequisite for assuming that the fixed place of business is not a permanent establishment. This will be the case even if the contracts necessary for establishing and carrying on the business are concluded by those in charge of the places of business themselves. The employees of places of business within the meaning of paragraph 4 who are authorised to conclude such contracts should not be regarded as agents within the meaning of paragraph 5. A case in point would be a research institution the manager of which is authorised to conclude the contracts necessary for maintaining the institution and who exercises this authority within the framework of the functions of the institution. A permanent establishment, however, exists if the fixed place of business exercising any of the functions listed in paragraph 4 were to exercise them not only on behalf of the enterprise to which it belongs but also on behalf of other enterprises. If, for instance, an advertising agency maintained by an enterprise were also to [p. 71] engage in advertising for other enterprises, it would be regarded as a permanent establishment of the enterprise by which it is maintained.

"If a fixed place of business under paragraph 4 is deemed not to be a permanent establishment, this exception applies likewise to the disposal of movable property forming part of the business property of the place of business at the termination of the enterprise's activity in such installation. Since, for example, the display of merchandise is excepted under subparagraphs (*a*) and (*b*), the sale of the merchandise at the termination of a trade fair or convention is covered by this exception. The

exception does not, of course, apply to sales of merchandise not actually displayed at the trade fair or convention.

"A fixed place of business used both for activities which rank as exceptions (paragraph 4) and for other activities would be regarded as a single permanent establishment and taxable as regards both types of activities. This would be the case, for instance, where a store maintained for the delivery of goods also engaged in sales."

Paragraph 5

Since neither paragraph 4 nor paragraph 5 deals with the treatment of a combination of the activities specified in subparagraph 4 (*a*) to subparagraph 4 (*e*), whatever interpretation is given to the omission in paragraph 4 should also apply to paragraph 5. With the addition of subparagraph 5 (*b*), this paragraph departs substantially from and is considerably broader in scope than article 5, paragraph 5, of the OECD Model Convention, which the Group considered to be too narrow in scope because it restricted the type of agent who would be deemed to create a permanent establishment of a non-resident enterprise, exposing it to taxation in the source country.

Some members from developing countries pointed out that a narrow formula might encourage tax evasion by permitting an agent who was in fact dependent to represent himself as acting on his own behalf. It was the understanding of the Group that the phrase "authority to conclude contracts on behalf of" in subparagraph 5 (*a*) of article 5 meant that the agent had legal authority to bind the enterprise for business purposes and not only for administrative purposes (e.g., conclusion of lease or electricity and manpower contracts).

Paragraph 6

This paragraph does not correspond to any provision of the OECD Model Convention. It was included because it was the common feeling of the Group that the OECD definition of permanent [p. 72] establishment was not adequate to deal with certain aspects of the insurance business. Members from develop-

ing countries pointed out that if an insurance agent was independent, the profits would not be taxable in accordance with the provisions suggested in article 5, paragraph 7, of the United Nations Model Convention (based on article 5, paragraph 6, of the OECD Model Convention); and if the agent was dependent, no tax could be imposed because insurance agents normally had no authority to conclude contracts as would be required under the provisions suggested in subparagraph 5(*a*) (based on article 5, paragraph 5, of the OECD Model Convention). Those members expressed the view that taxation of insurance profits in the country where the premiums were being paid was desirable and should take place independently of the status of the agent. They therefore suggested that the United Nations Model Convention should include a special provision relating to insurance business. However, such taxation is based on the assumption that the person (employee or representative) through whom premiums are collected and risk insured, is present in the country where the risk is located.

Once agreement had been reached on the principle of including a special provision on insurance, the discussion in the Group focused mainly on cases involving representation through "an independent agent". Members from developing countries felt it would be desirable to provide that a permanent establishment existed in such cases because of the nature of the insurance business, the fact that the risks were situated within the country claiming tax jurisdiction, and the facility with which persons could, on a part-time basis, represent insurance companies on the basis of an "independent status", making it difficult to distinguish between dependent and independent insurance agents. Members from developed countries, on the other hand, stressed that in cases involving independent agents, insurance business should not be treated differently from such activities as the sale of tangible commodities. Those members also drew attention to the difficulties involved in ascertaining the total amount of business done when the insurance was handled by a number of independent agents within the same country. In view of the difference in approach, the Group agreed that the case of representation through independent agents should be left to bilateral negotiations, which could take account of the methods used to sell

insurance and other features of the insurance business in the countries concerned.

Paragraph 7

The first sentence of this paragraph reproduces article 5, paragraph 6, of the OECD Model Convention in its entirety, with a few minor drafting changes. the commentary on the OECD text reads as follows:

"Where an enterprise of a Contracting State carries on business [p. 73] dealings through a broker, general commission agent or any other agent of an independent status, it cannot be taxed in the other Contracting State in respect of those dealings if the agent is acting in the ordinary course of his business . . . Although it stands to reason that such an agent, representing a separate enterprise, cannot constitute a permanent establishment of the foreign enterprise, paragraph 6 has been inserted in the article for the sake of clarity and emphasis.

"A person will come within the scope of paragraph 6 — i.e. he will not constitute a permanent establishment of the enterprise on whose behalf he acts — only if

"(*a*) he is independent of the enterprise both legally and economically,

"(*b*) he acts in the ordinary course of his business when acting on behalf of the enterprise.

"Whether a person is independent of the enterprise represented depends on the extent of the obligations which this person has vis-à-vis the enterprise. Where the person's commercial activities for the enterprise are subject to detailed instructions or to comprehensive control by it, such person cannot be regarded as independent of the enterprise. Another important criterion will be whether the entrepreneurial risk has to be borne by the person or by the enterprise the person represents. A subsidiary is not to be considered dependent on its parent company solely because of the parent's ownership of the share capital. Persons cannot be said to act in the ordinary course of their own business if, in place of the enterprise, such

persons perform activities which, economically, belong to the sphere of the enterprise rather than to that of their own business operations. Where, for example, a commission agent not only sells the goods or merchandise of the enterprise in his own name but also habitually acts, in relation to that enterprise, as a permanent agent having an authority to conclude contracts, he would be deemed in respect of this particular activity to be a permanent establishment, since he is thus acting outside the ordinary course of his own trade or business (namely that of a commission agent), unless his activities are limited to those mentioned at the end of paragraph 5.

". . . . ."

The second sentence of article 5, paragraph 7, of the United Nations Model Convention constitutes a new provision, whose inclusion stemmed from a proposal by members from developing countries to broaden the scope of the definition of a permanent establishment by treating as a dependent agent an agent who habitually secures orders exclusively or almost exclusively for an enterprise of the other Contracting State or a group of centrally controlled affiliated enterprises. In that situation, the agent shall constitute a permanent [p. 74] establishment for the particular members of the group for whom he is acting at a given time. In support of this proposal it was argued that when an agent, although acting in an independent capacity, acted for only one enterprise and devoted his time and activity wholly or almost wholly to that enterprise, he lost his independent status.

It was stated that the confinement of the activities of an agent wholly or almost wholly to those undertaken on behalf of one enterprise must be pursuant to an agreement with that enterprise. Some members from developing countries felt that the existence of such an agreement should not be a requirement for the application of the United Nations amendment replacing article 5, paragraph 5, of the OECD Model Convention, for in practice it would annul it.

Paragraph 8

This paragraph reproduces article 5, paragraph 7, of the OECD Model Convention. The commentary on the OECD text reads as follows:

"It is generally accepted that the existence of a subsidiary company does not, of itself, constitute that subsidiary company a permanent establishment of its parent company. This follows from the principle that, for the purpose of taxation, such a subsidiary company constitutes an independent legal entity. Even the fact that the trade or business carried on by the subsidiary company is managed by the parent company does not constitute the subsidiary company a permanent establishment of the parent company.

"However, a subsidiary company will constitute a permanent establishment for its parent company under the same conditions stipulated in paragraph 5 as are valid for any other unrelated company, i.e. if it cannot be regarded as an independent agent in the meaning of paragraph 6, and if it has and habitually exercises an authority to conclude contracts in the name of the parent company. And the effects would be the same as for any other unrelated company to which paragraph 5 applies.

"The same rules should apply to activities which one subsidiary carries on for any other subsidiary of the same company."

C. OBSERVATIONS ON THE OECD COMMENTARY AND RESERVATIONS ON ARTICLE 5 OF THE OECD MODEL CONVENTION

Observations on the commentary

"Treatment in Irish tax law of non-resident operators in *Ireland* and in the Irish continental shelf area. Profits arising to a person not resident in Ireland from exploration or exploitation [p. 75] activities in Ireland or in the Irish continental shelf area as well as profits from exploration or exploitation rights are treated as the profits of a trade carried on in Ireland through a

branch or agency and are, in consequence, taxable in Ireland. This includes non-resident contractors who supply well-drilling, pipe-laying and similar services in Ireland or in the Irish continental shelf area. In addition, capital gains accruing on the disposal of exploration or exploitation rights in Ireland or in the Irish continental shelf area are treated as gains accruing on the disposal of assets situated in Ireland. When negotiating conventions with other Member countries, Ireland would wish subparagraph *(f)* of paragraph 2 to be so drafted and interpreted as to reflect the Irish position.

"*Italy* does not adhere to the interpretation given in paragraph 11 above concerning the list of examples of paragraph 2. In its opinion, these examples can always be regarded as constituting *a priori* permanent establishments.

"While, subject to its reservations in relation to this Article, *New Zealand*, for the purpose of negotiating conventions with other Member countries, accepts, in general, the principles of this Article, it would wish to be free to negotiate for the addition of specific provisions deeming an enterprise in some particular situations to have a permanent establishment in New Zealand."

Reservations on the article

"*Australia* reserves the right to treat an enterprise as having a permanent establishment in a State if the enterprise carries on designated supervisory activities in that State for more than twelve months, if substantial equipment is used in that State for more than twelve months by, for or under contract with the enterprise in the exploration for or exploitation of natural resources, or if a person acting in that State on behalf of the enterprise — manufactures or processes there goods or merchandise belong to the enterprise.

"*Greece, New Zealand, Portugal* and *Turkey* reserve their positions on paragraph 3, and consider that any building site or construction or installation project which lasts more than six months should be regarded as a permanent establishment.

"*New Zealand* also reserves its position so as to be able to tax an enterprise which carries on supervisory activities for more than six months in connection with a building site or construction or installation project lasting more than six months, and also an enterprise where substantial equipment or machinery is for more than six months being used by, for or under contract with the enterprise.

"*Spain* reserves its position on paragraph 3 so as to be able [p. 76] to tax an enterprise having a permanent establishment in Spain, even if the site of the construction or installation project does not last for more than twelve months, where the activity of this enterprise in Spain presents a certain degree of permanency within the meaning of paragraphs 1 and 2."

* * *

[p. 79] Article 7

BUSINESS PROFITS

A. GENERAL CONSIDERATIONS

Article 7 of the United Nations Model Convention consists of a number of provisions of article 7 of the OECD model Convention, either unchanged or substantially amended, and some new provisions. In particular paragraph 5 of article 7 of the OECD text has not been included. The Group of Experts could not reach a consensus on provisions relating to the matters covered by that paragraph and therefore decided to include in article 7 a note indicating that the question of whether profits should be attributed to a permanent establishment by reason of the mere purchase by that permanent establishment of goods or merchandise for the enterprise should be settled in bilateral negotiations. The members from developing countries considered that that paragraph should not be reproduced in the article, or, if it was included, it should be amended to include a statement to the effect that in the case of a permanent establishment engaged in purchasing and other activities, profits derived from purchasing activities should be attributed to the permanent establishment. Furthermore, some members from developing countries felt that where purchasing constituted the sole activity of an enterprise in the source country, a permanent establishment would exist in that

country, and that since the purchasing activity contributed to the generation of the over-all profit of the enterprise, there should be an allocation of the portion of the over-all profit attributable to the permanent establishment. The members from developed countries believed that it would be desirable to incorporate the provisions of article 7, paragraph 5, in the text of article 7. Details concerning the other amendments to the OECD text and the new provisions are provided below in the commentary on the paragraphs of the article.

The most relevant question in international tax practice concerning business profits relates to the facts which make an enterprise liable to taxation on its profits in a foreign country. There is general acceptance of the so-called "arm's-length" rule embodied in the [p. 80] OECD Draft Model Convention. According to this rule, the profits attributable to a permanent establishment are those which would be earned by the establishment if it were a wholly independent entity dealing with its head office as if it were a distinct and separate enterprise operating under conditions and selling at prices prevailing in the regular market. The profits so attributable are normally the profits shown on the books of the establishment. Nevertheless, this rule permits the authorities of the country in which the permanent establishment is located to rectify the accounts of the enterprise, so as to reflect properly income which the establishment would have earned if it were an independent enterprise dealing with its head office at arm's length. The application of the arm's-length rule to the allocation of profits between the home office and its permanent establishment presupposes for most countries that the domestic legislation authorizes a determination on the basis of the arm's-length principle.

The application of the arm's-length rule is particularly important in connexion with the difficult and complex problem of the deductions to be allowed to the permanent establishment. It is also generally accepted that in calculating the profits of a permanent establishment, allowance should be made for expenses, wherever incurred, for the purposes of the business of the permanent establishment, including executive and general administrative expenses. Apart from what may be regarded as ordinary

expenses, there are some classes of expenditure that give rise to special problems. These include interest and royalties etc. paid by the permanent establishment to its head office in return for money lent or patent rights licensed by the latter to the permanent establishment. They further include commissions (except for the reimbursement of actual expenses) for specific services or for the exercise of management services by the enterprise for the benefit of the establishment. In these cases, it is considered that the payments should not be allowed as deductions in computing the profits of the permanent establishment. Conversely, such payments made to a permanent establishment by the head office should be excluded from the profits of the permanent establishment. On the other hand, an allocable share of such payments, e.g., interest and royalties, paid by the enterprise to third parties should be allowed.

Although according to the OECD Model Convention only profits attributable to the permanent establishment should be taxable in the source country, in some cases the "attribution principle" has been amplified by the so-called "force of attraction" rule, which permits the enterprise, once it carries out business through a permanent establishment in the source country, to be taxed on business profits in that country arising from transactions outside the permanent establishment. Furthermore, non-business income of the enterprise may likewise be attracted into the taxable income of the permanent establishment. Where, owing to the principle of the "force of attraction", [p. 81] the profits of an enterprise other than those attributable directly to the permanent establishment may be taxed in the State where the permanent establishment is situated, such profits should be determined in the same way as if they were attributable directly to the permanent establishment.

It may be recalled that the OECD Model Convention contains the following preliminary remarks on article 7:

"This Article is in many respects a continuation of, and a corollary to, Article 5 on the definition of the concept of permanent establishment. The permanent establishment criterion is commonly used in international double taxation conventions to determine whether a particular kind of income shall or

shall not be taxed in the country from which it originates but the criterion does not of itself provide a complete solution to the problem of the double taxation of business profits; in order to prevent such double taxation it is necessary to supplement the definition of permanent establishment by adding to it an agreed set of rules of reference to which the profits made by the permanent establishment, or by an enterprise trading with a foreign member of the same group of enterprises, are to be calculated. To put the matter in a slightly different way, when an enterprise of a Contracting State carries on business in the other Contracting State the authorities of that second State have to ask themselves two questions before they levy tax on the profits of the enterprise: the first question is whether the enterprise has a permanent establishment in their country; if the answer is in the affirmative the second question is what, if any, are the profits on which that permanent establishment should pay tax. It is with the rules to be used in determining the answer to this second question that Article 7 is concerned. Rules for ascertaining the profits of an enterprise of a Contracting State which is trading with an enterprise of the other Contracting State when both enterprises are members of the same group of enterprises or are under the same effective control are dealt with in Article 9.

"It should perhaps be said at this point that neither Article is strikingly novel or particularly detailed. The question of what criteria should be used in attributing profits to a permanent establishment, and of how to allocate profits from transactions between enterprises under common control, has had to be dealt with in a large number of double taxation conventions and it is fair to say that the solutions adopted have generally conformed to a standard pattern. It is generally recognized that the essential principles on which this standard pattern is based are well founded, and it has been thought sufficient to restate them with some slight amendments and modifications primarily aimed at producing greater clarity. The two Articles incorporate a number [p. 82] of directives. They do not, nor in the nature of things could they be expected to, lay down a series of precise rules for dealing with every kind of problem that may arise when an enterprise of one State makes profits in another.

Modern commerce organizes itself in an infinite variety of ways, and it would be quite impossible within the fairly narrow limits of an article in a double taxation convention to specify an exhaustive set of rules for dealing with every kind of problem that may arise. This, however, is a matter of relatively minor importance, if there is agreement on general lines. Special cases may require special consideration, but it should not be difficult to find an appropriate solution if the problem is approached within the framework of satisfactory rules based on agreed principles."

B. COMMENTARY ON THE PARAGRAPHS OF ARTICLE 7

Paragraph 1

This paragraph reproduces article 7, paragraph 1, of the OECD Model Convention, with the addition of the provisions contained in clauses (*b*) and (*c*). In the discussion preceding the adoption by the Group of Experts of this paragraph, several members from developing countries expressed support for the "force of attraction" rule, although they would limit the application of that rule to business profits covered by article 7 of the OECD Model Convention and not extend it to income from capital (dividends, interest and royalties) covered by other treaty provisions. The members supporting the application of the "force of attraction" rule also indicated that neither sales through independent commission agents nor purchase activities would become taxable to the principal under that rule. Some members from developed countries pointed out that the "force of attraction" rule had been found unsatisfactory and abandoned in recent tax treaties concluded by them because of the undesirability of taxing income from an activity that was totally unrelated to the establishment and that was in itself not extensive enough to constitute a permanent establishment. They also stressed the uncertainty that such an approach would create for taxpayers. Members from developing countries pointed out that the proposed "force of attraction" approach did remove some administrative problems in that it made it unnecessary to determine whether particular

activities were or were not related to the permanent establishment or the income involved attributable to it. That was the case especially with respect to transactions conducted directly by the home office within the country, but similar in nature to those conducted by the permanent establishment. However, after discussion, it was proposed that the "force of attraction" rule, should be limited so that it would apply to sales of goods or merchandise and other business activities in the following manner: if an enterprise has [p. 83] a permanent establishment in the other Contracting State for the purpose of selling goods or merchandise, sales of the same or a similar kind may be taxed in that State even if they are not conducted through the permanent establishment; a similar rule will apply if the permanent establishment is used for other business activities and the same or similar activities are performed without any connexion with the permanent establishment.

Clauses (*b*) and (*c*) were deemed entirely acceptable by the members from developing countries and a few members from developed countries. Other members from developed countries said that they could accept clauses (*b*) and (*c*) if those clauses were understood not to extend to sales effected by agents of an independent status. Others believed that such an exception would be less acceptable than either the original OECD provision or that provision amended by clauses (*b*) and (*c*). In effect, if that exception were admitted, taxation in the host country would depend upon whether an independent commission agent or broker was involved, which they felt would not be a logical distinction and would, moreover, lend itself to artificial sales arrangements. A few members from developed countries thought that the addition of clauses (*b*) and (*c*) was undesirable and preferred the OECD text.

It may be recalled that the OECD Model Convention contains the following commentary on the provisions of paragraph 1 of article 7 of that Convention.

"This paragraph is concerned with two questions. First, it restates the generally accepted principle of double taxation conventions that an enterprise of one State shall not be taxed in the other State unless it carries on business in that other State through a permanent establishment situated therein. It is hardly necessary to argue here the merits of this principle. It is perhaps sufficient to say that it has come to be accepted in international fiscal matters that until an enterprise of one State sets up a permanent establishment in another State it should not properly be regarded as participating in the economic life of that other State to such an extent that it comes within the jurisdiction of that other State's taxing rights.

"The second and more important point is that it is laid down — in the second sentence — that when an enterprise carries on business through a permanent establishment in another State that State may tax the profits of the enterprise but only so much of them as is attributable to the permanent establishment; in other words that the right to tax does not extend to profits that the enterprise may derive from that State otherwise than through the permanent establishment. This is a question on which there may be differences of view. Some countries have taken the view that when a foreign enterprise has set up a permanent establishment [p. 84] within their territory it has brought itself within their fiscal jurisdiction to such a degree that they can properly tax all profits that the enterprise derives from their territory, whether the profits come from the permanent establishment or from other activities in that territory. But it is thought that it is preferable to adopt the principle contained in the second sentence of paragraph 1, namely that the test that business profits should not be taxed unless there is a permanent establishment is one that should properly be applied not to the enterprise itself but to its profits. To put the matter another way, the principle laid down in the second sentence of paragraph 1 is based on the view that in taxing the profits that a foreign enterprise derives from a particular country, the fiscal authorities of that country should look at the separate sources of profit that the enterprise derives from their country and should apply to each the permanent establishment test. This is of course without prejudice to other articles.

"On this matter, naturally, there is room for differences of view, and since it is an important question it may be useful to set out the arguments for each point of view.

"Apart from the background question of fiscal jurisdiction, the main argument commonly put forward against the solution advocated above is that there is a risk that it might facilitate avoidance of tax. This solution, the argument runs, might leave it open to an enterprise to set up in a particular country a permanent establishment which made no profits, was never intended to make profits, but existed solely to supervise a trade, perhaps of an extensive nature, that the enterprise carried on in that country through independent agents and the like. Moreover, the argument goes, although the whole of this trade might be directed and arranged by the permanent establishment, it might be difficult in practice to prove that was the case. If the rates of tax are higher in that country than they are in the country in which the head office is situated, then the enterprise has a strong incentive to see that it pays as little tax as possible in the other territory; the main criticism of the solution advocated above is that it might conceivably provide the enterprise with a means of ensuring that result.

"Apart again from the question of the proper extent of fiscal jurisdiction, the main argument in favour of the proposed solution is that it is conducive to simple and efficient administration, and that it is more closely adapted to the way in which business is commonly transacted. The organization of modern business is highly complex. In OECD Member countries, there are a considerable number of companies each of which is engaged in a wide diversity of activities and is carrying on business extensively in many countries. It may be that such a company may have set up [p. 85] a permanent establishment in a second country and may be transacting a considerable amount of business through that permanent establishment in one particular kind of manufacture; that a different part of the same company may be selling quite different goods or manufactures in that second country through independent agents; and that the company may have perfectly genuine reasons for taking this course — reasons based on, for example, either on the historical pattern of its business or on commercial convenience. Is it desirable that the fiscal authorities should go so far as to insist on trying to search out the profit element of each of the transactions carried on through independent agents, with a

view to aggregating that profit with the profits of the permanent establishment? Such an article might interfere seriously with ordinary commercial processes, and so be out of keeping with the aims of the Convention.

"It is no doubt true that evasion of tax could be practiced by undisclosed channelling of profits away from a permanent establishment and that this may sometimes need to be watched, but it is necessary in considering this point to preserve a sense of proportion and to bear in mind what is said above. It is not, of course, sought in any way to sanction any such malpractice, or to shelter any concern thus evading tax from the consequences that would follow from detection by the fiscal authorities concerned. It is fully recognised that Contracting States should be free to use all methods at their disposal to fight fiscal evasion.

"For the reasons given above, it is thought that the argument that the solution advocated might lead to increase avoidance of tax by foreign enterprises should not be given undue weight. Much more importance is attached to the desirability of interfering as little as possible with existing business organization and of refraining from inflicting demands for information on foreign enterprises which unnecessarily onerous."

Paragraph 2

This paragraph reproduces article 7, paragraph 2, of the OECD Model Convention. In the discussion relating to that paragraph, a member from a developed country pointed out that his country was having some problems with inconsistent determination of the profits properly attributable to a permanent establishment, especially with regard to "turn-key" contracts. It was recalled that under a turn-key contract a contractor agreed to construct a factory or similar facility and make it ready for operation. When the facility was ready for operation, it was handed over to the purchaser, who could then begin operations. The international tax problems occurred when the facility was to be constructed in one country by a contractor resident in [p. 86] another country. The actual construction activities carried on in one country clearly constituted a permanent establishment within that country if of

sufficiently long duration. Turn-key contracts, however, were often concluded before the creation of the permanent establishment and involved many components other than normal construction activities. They also included the purchase of capital goods, the performance of architectural and engineering services and the provision of technical assistance. Those latter items, it was explained, were sometimes completed before construction activities actually started (and hence, before the creation of a permanent establishment at the construction site) and often outside the country in which the construction site/permanent establishment was situated.

The question thus arose how much of the total profits of the turn-key contract was properly attributable to the permanent establishment and thus taxable in the country in which it was situated. A member from a developed country said that he knew of instances in which countries had sought to attribute the entire profits of the contract to the permanent establishment. It was his view, however, that only the profits attributable to activities carried on by the permanent establishment should be taxed in the country in which the permanent establishment was situated, unless the profits included items of income dealt with separately in other articles of the Convention and were taxable in that country accordingly.

The Group recognized that that problem was a complex and potentially controversial one involving many interrelated issues, such as source of income rules and the definitions of permanent establishment and profits of an enterprise. The Group acknowledged that the problem might be considered in the course of bilateral negotiations. Since the discussion resulted in no change in article 7, paragraph 2, of the OECD Model Convention, the whole of the OECD commentary on that paragraph, which reads as follows, is relevant to the United Nations text:

"This paragraph contains the central directive on which the allocation of profits to a permanent establishment is intended to be based. The paragraph incorporates the view, which is generally contained in bilateral conventions, that the profits to be attributed to a permanent establishment are those which that permanent establishment would have made if, instead of dealing with its head office, it had been dealing with an entirely separate enterprise under conditions and at prices prevailing in the ordinary market. Normally, these would be the same profits that one would expect to be determined by the ordinary processes of good business accountancy. This principle also extends to the allocation of profits which the permanent establishment may derive from transactions with other permanent establishments of the enterprise and with associated companies and their permanent [p. 87] establishments; but Contracting States which consider that the existing paragraph does not in fact cover these more general transactions may, in their bilateral negotiations, agree upon more detailed provisions.

"In the great majority of cases, trading accounts of the permanent establishment — which are commonly available if only because a well-run business organisation is normally concerned to know what is the profitability of its various branches — will be used by the taxation authorities concerned to ascertain the profit properly attributable to that establishment. Exceptionally there may be no separate accounts. . . . But where there are such accounts they will naturally form the starting point for any processes of adjustment in case adjustment is required to produce the amount of properly attributable profits. It should perhaps be emphasized that the directive contained in paragraph 2 is no justification for tax administrations to construct hypothetical profit figures in vacuo; it is always necessary to start with the real facts of the situation as they appear from the business records of the permanent establishment and to adjust as may be shown to be necessary the profit figures which those facts produce. It should also be noted that the principle set out in paragraph 2 is subject to the provisions contained in paragraph 3, especially as regards the treatment of payments which, under the name of interest, royalties, etc. are made by a permanent establishment to its head office in return for money loaned, or patent rights conceded by the latter to the permanent establishment.

"Even where a permanent establishment is able to produce proper accounts which purport to show the profits arising from its activities, it may still be necessary for the taxation authori-

ties of the country concerned to rectify those accounts in accordance with the general directive laid down in paragraph 2. Adjustment of this kind may be necessary, for example, because goods have been invoiced from the head office to the permanent establishment at prices which are not consistent with this directive, and profits have thus been diverted from the permanent establishment to the head office, or vice versa.

"In such cases, it will usually be appropriate to substitute for the prices used ordinary market prices for the same or similar goods supplied on the same or similar conditions. Clearly the price at which goods can be bought on open market terms varies with the quantity required and the period over which they will be supplied; such factors would have to be taken into account in deciding the open market price to be used. It is perhaps only necessary to mention at this point that there may sometimes be perfectly good commercial reasons for an enterprise invoicing its goods at prices less than those prevailing in the ordinary market; [p. 88] this may, for example, be a perfectly normal commercial method of establishing a competitive position in a new market and should not then be taken as evidence of an attempt to divert profits from one country to another. Difficulties may also occur in the case of proprietary goods produced by an enterprise, all of which are sold through its permanent establishments; if in such circumstances there is no open market price, and it is thought that the figures in the accounts are unsatisfactory, it may be necessary to calculate the permanent establishment's profits by other methods, for example, by applying an average ratio of gross profit to the turnover of the permanent establishment and then deducting from the figures so obtained the proper amount of expenses incurred. Clearly many special problems of this kind may arise in individual cases but the general rule should always be that the profits attributed to a permanent establishment should be based on that establishment's accounts insofar as accounts are available which represent the real facts of the situation. If available accounts do not represent the real facts then new accounts will have to be constructed, or the original ones rewritten, and for this purpose the figures to be used will be those prevailing in the open market.

"Some States consider that there is a realisation of a taxable profit when an asset, other than trading stock, forming part of the business property of a permanent establishment situated within their territory is transferred to a permanent establishment or the head office of the same enterprise situated in another State. Article 7 allows such States to tax profits deemed to arise in connexion with such a transfer. Such profits may be determined as indicated in [the preceding four paragraphs]."

Paragraph 3

The first sentence of paragraph 3 of article 7 reproduces the entire text of article 7, paragraph 3, of the OECD Model Convention. The rest of the paragraph consists of new provisions formulated by the Group of Experts. These provisions stem from a proposal by members from developing countries, who felt that it would be helpful to include all the necessary definitions and clarifications in the text, with a view, in particular, to assisting developing countries not represented in the Group. Some of those members also felt that provisions prohibiting the deduction of certain expenses should be included in the text of a bilateral tax treaty to make it clear that taxpayers were fully informed about their fiscal obligations. In the course of the discussion it was pointed out that the additions to the OECD text would ensure that the permanent establishment would be able to deduct interest, royalties and other expenses incurred by the head office on behalf of the establishment. The Group agreed that if billings [p. 89] by the head office included the full costs, both direct and indirect, then there should not be a further allocation of the executive and administrative expenses of the head office, since that would produce a duplication of such charges on the transfer between the head office and the permanent establishment. It was pointed out that it was important to determine how the price was fixed and what elements of cost it included. Where an international wholesale price was used, it would normally include indirect costs. There was general agreement within the Group that any duplication of costs and expenses should be prevented.

Since the first sentence of article 7, paragraph 3, of the United Nations Model Convention reproduces the whole of article 7, paragraph 3, of the OECD Model Convention, the OECD commentary on the latter paragraph, which reads as follows, is relevant to the United Nations text:

"This paragraph clarifies, in relation to the expenses of a permanent establishment, the general directive laid down in paragraph 2. The paragraph specifically recognises that in calculating the profits of a permanent establishment allowance is to be made for expenses, wherever incurred, that were incurred for the purposes of the permanent establishment. Clearly in some cases it will be necessary to estimate or to calculate by conventional means the amount of expenses to be taken into account. In the case, for example, of general administrative expenses incurred at the head office of the enterprise, it may be appropriate to take into account a proportionate part based on the ratio that the permanent establishment's turnover (or perhaps gross profits) bears to that of the enterprise as a whole. Subject to this, it is considered that the amount of expenses to be taken into account as incurred or the purposes of the permanent establishment should be the actual amount so incurred. The deduction allowable to the permanent establishment for any of the expenses of the enterprise attributed to it does not depend upon the actual reimbursement of such expenses by the permanent establishment.

"Apart from what may be regarded as ordinary expenses, there are some classes of payments between permanent establishments and head offices which give rise to special problems, and it is convenient to deal with them at this point. The next paragraphs discuss three specific cases of this kind and give solutions for them. It should not, of course, be inferred that it is only in relation to the three classes of payments mentioned in these paragraphs that problems may arise; there may well be payments of other kinds to which similar considerations apply.

"The first of these cases relates to payments which under the name of interest, royalties, etc. are made by a permanent [p. 90] establishment to its head office in return for money loaned, or patent rights conceded, by the latter to the permanent establishment. In such a case, it is considered that the payments should not be allowed as deductions in computing the permanent establishment's taxable profits. Equally, such payments made to a permanent establishment by the head office should be excluded from the computation of the permanent establishment's taxable profits. It is, however, recognised that special considerations apply to payments of interest made by different parts of a financial enterprise (e.g. a bank) to each other on advances etc. (as distinct from capital allotted to them), in view of the fact that making and receiving advances is narrowly related to the ordinary business of such enterprises. Furthermore, if an enterprise makes payments of interest, etc. to a third party and these payments in part relate to the activities of the permanent establishment, then a proportionate part of them should naturally be taken into account in calculating the permanent establishment's profits insofar as they can properly be regarded as expenses incurred for the purposes of the permanent establishment.

"The second case relates to the performance of ancillary services by a permanent establishment on behalf of its head office or vice versa. Consider, for example, the case of a large company with a varied business, part of which it carries on in another country through a permanent establishment. In addition, that permanent establishment advertises on behalf of its head office goods which that enterprise produces but which the permanent establishment itself does not handle. Clearly, in calculating for tax purposes the profits of the permanent establishment, the profit should be increased by the amount of the expense it has incurred on behalf of the head office (unless, of course, such an adjustment has already been made in drawing up the accounts of the permanent establishment). In fact if the permanent establishment and its head office were entirely separate and independent, the permanent establishment would ordinarily carry out services for the head office only if it were paid a commission as well as reimbursed the actual expenses incurred. It is, therefore, necessary to decide whether the calculation should be made on the basis of account being taken not only of any expenses borne by a permanent establishment by reason of services performed for the head office but also of a

notional commission increasing the profits of the permanent establishment.

"After consideration of this question, it is thought that in such circumstances the profits of the permanent establishment should not be increased by the addition of a 'commission' figure. While, on one view, to include a 'commission' figure in the profits of every permanent establishment that has performed services [p. 91] otherwise than for its own purposes could be looked at in theory as a consequential application of the fiction of separate enterprise, it would inevitably be found exceedingly cumbersome in practice. There would be scope for lengthy argument about, and usually no concrete basis for determining, the percentage to be used in calculating the amount of notional 'commission'. In the great majority of cases the accounts of the permanent establishment would doubtless take into consideration actual expenses incurred; in other words they would not normally include any credit for 'commission'. If as a general rule the 'separate enterprise' test were to be applied to services performed by a permanent establishment on behalf of its head office and a notional 'commission' profit were to be included in the profits of the permanent establishment, it would, therefore, be necessary in the great majority of cases first to settle how the 'commission' element was to be calculated and then re-write the accounts of the permanent establishment. Considerations of practical administration weigh heavily against such a course. Therefore no 'commission' element should in such cases be included in the profits of the permanent establishment. Similarly, in the converse case where the head office undertakes services on behalf of the permanent establishment, no 'commission' element should be deducted in determining the profits of the permanent establishment.

"The third case is related to the question whether any part of the total profits of an enterprise should be deemed to arise from the exercise of good management. Consider the case of a company that has it head office in one country but carries on all its business through a permanent establishment situated in another country. In the extreme case it might well be that only the directors' meetings were held at the head office and that all

other activities of the company, apart from purely formal legal activities, were carried on in the permanent establishment. In such a case there is something to be said for the view that at least part of the profits of the whole enterprise arose from the skilful management and business acumen of the directors and that part of the profits of the enterprise ought, therefore, to be attributed to the country in which the head office was situated. If the company has been managed by a managing agency, then that agency would doubtless have charged a fee for is services and the fee might well have been a simple percentage participation in the profits of the enterprise. But, once again, whatever the theoretical merits of such a course, practical considerations weigh heavily against it. In the kind of case quoted the expenses of management would, of course, be set against the profits of the permanent establishment in accordance with the provisions of paragraph 3, but when the matter is looked at as a whole, it is thought that it would not be right to go further by deducting and taking into account some [p. 92] notional figure for 'profits of management'. In cases identical to the extreme case mentioned above, no account should therefore be taken in determining taxable profits of the permanent establishment of any notional figure such as profits of management.

"It may be, of course, that countries where it has been customary to allocate some proportion of the total profits of an enterprise to the head office of the enterprise to represent the profits of good management will wish to continue to make such an allocation. Nothing in the article is designed to prevent this. Nevertheless it follows from what is said in the above paragraph that a country in which a permanent establishment is situated is in no way required to deduct when calculating the profits attributable to that permanent establishment an amount intended to represent a proportionate part of the profits of management attributable to the head office.

"It might well be that if the country in which the head office of an enterprise is situated allocates to the head office some percentage of the profits of the enterprise only in respect of good management, while the country in which the permanent establishment is situated does not, the resulting total of the

amounts charged to tax in the two countries would be greater than it should be. In any such case the country in which the head office of the enterprise is situated should take the initiative in arranging for such adjustments to be made in computing the taxation liability in that country as may be necessary to ensure that any double taxation is eliminated.

"It is usually found that there are, or there can be constructed, adequate accounts for each part or section of an enterprise so that profits and expenses, adjusted as may be necessary, can be allocated to a particular part of the enterprise with a considerable degree of precision. This method of allocation is, it is thought, to be preferred in general wherever it is reasonably practicable to adopt it. There are, however, circumstances in which this may not be the case and paragraphs 2 and 3 are in no way intended to imply that other methods cannot properly be adopted where appropriate in order to arrive at the profits of a permanent establishment on a 'separate enterprise' footing. It may well be, for example, that profits of insurance enterprises can most conveniently be ascertained by special methods of computation, e.g. by applying appropriate co-efficients to gross premiums received from policy holders in the country concerned. Again, in the case of a relatively small enterprise operating on both sides of the (b) order between two countries, there may be no proper accounts for the permanent establishment nor means of constructing them. There may, too, be other cases where the affairs of the permanent establishment are so closely bound up [p. 93] with those of the head office that it would be impossible to disentangle them on any strict basis of branch accounts. Where it has been customary in such cases to estimate the arm's length profit of a permanent establishment by reference to suitable criteria, it may well be reasonable that that method should continue to be followed notwithstanding that the estimate thus made may not achieve as high a degree of accurate measurement of the profit as adequate accounts. Even where such a course has not been customary, it may, exceptionally, be necessary for practical reasons to estimate the arm's length profits."

Some countries wished to point out that they allowed only those deductions that were permitted by their domestic laws.

Paragraph 4

This paragraph reproduces article 7, paragraph 4, of the OECD Model Convention. The OECD commentary on the latter paragraph, which reads as follows, is therefore relevant to the United Nations text:

"It has in some cases been the practice to determine the profits to be attributed to a permanent establishment not on the basis of separate accounts or by making an estimate of arm's length profit, but simply by apportioning the total profits of the enterprise by reference to various formulae. Such a method differs from those envisaged in paragraph 2, since it contemplates not an attribution profits on a separate enterprise footing, but an apportionment of total profits; and indeed it might produce a result in figures which would differ from that which would be arrived at by a computation based on separate accounts. Paragraph 4 makes it clear that such a method may continue to be employed by a Contracting State if it has been customary in that State to adopt it, even though the figure arrived at may at times differ to some extent from that which would be obtained from separate accounts, provided that the result can fairly be said to be in accordance with the principles contained in the article. It is emphasized, however, that in general the profits to be attributed to a permanent establishment should be determined by reference to the establishment's accounts if these reflect the real facts. It is considered that a method of allocation which is based on apportioning total profits is generally not as appropriate as a method which has regard only to the activities of the permanent establishment and should be used only where exceptionally it has as a matter of history been customary in the past and is accepted in the country concerned both by the taxation authorities and taxpayers generally there as being satisfactory. It is understood that paragraph 4 may be deleted where neither State uses such a method. Where, however, Contacting States which to be able to [p. 94] use a method which was not been customary in the

past the paragraph should be amended during the bilateral negotiations to make this clear.

"It would not, it is thought, be appropriate within the framework of this Commentary to attempt to discuss at length the many various methods involving apportionment of total profits that have been adopted in particular fields for allocating profits. These methods have been well documented in treaties on international taxation. It may, however, not be out of place to summarize briefly some of the main types and to lay down some very general directives for their use.

"The essential character of a method involving apportionment of total profits is that a proportionate part of the profits of the whole enterprise is allocated to a part thereof, all parts of the enterprise being assumed to have contributed on the basis of the criterion or criteria adopted to the profitability of the whole. The difference between one such method and another arises for the most part from the varying criteria used to determine what is the correct proportion of the total profits. It is fair to say that the criteria commonly used can be grouped into three main categories, namely those which are based on the receipts of the enterprise, its expenses or its capital structure. The first category covers allocation methods based on turnover or on commission, the second on wages and the third on the proportion of the total working capital of the enterprise allocated to each branch or part. It is not, of course, possible to say in vacuo that any of these methods is intrinsically more accurate than the others; the appropriateness of any particular method will depend on the circumstances to which it is applied. In some enterprises, such as those providing services or producing proprietary articles with a high profit margin, net profits will depend very much on turnover. For insurance enterprises it may be appropriate to make an apportionment of total profits by reference to premiums received from policy holders in each of the countries concerned. In the case of an enterprise manufacturing goods with a high cost raw material or labour content, profits may be found to be related more closely to expenses. In the case of banking and financial concerns the proportion of total working capital may be the most relevant criterion. It is

considered that the general aim of any method involving apportionment of total profits ought to be to produce figures of taxable profit that approximate as closely as possible to the figures that would have been produced on a separate accounts basis, and that it would not be desirable to attempt in this connection to lay down any specific directive other than that it should be the responsibility of the taxation authority, in consultation with the authorities of other countries concerned, to use [p. 95] the method which in the light of all the known facts seems most likely to produce that result.

"The use of any method which allocates to a part of an enterprise a proportion of the total profits of the whole does, of course, raise question of the method to be used in computing the total profits of the enterprise. This may well be a matter which will be treated differently under the laws of different countries. This is not a problem which it would seem practicable to attempt to resolve by laying down any rigid rule. It is scarcely to be expected that it would be accepted that the profits to be apportioned should be the profits as they are computed under the laws of one particular country; each country concerned would have to be given the right to compute the profits according to the provisions of its own laws."

Paragraph 5

This paragraph reproduces article 7, paragraph 6, of the OECD Model Convention. In the words of the OECD commentary, the paragraph "is intended to lay down clearly that a method of allocation once used should not be changed merely because in a particular year some other method produces more favorable results. One of the purposes of a double taxation convention is to give an enterprise of a Contracting State some degree of certainty about the tax treatment that will be accorded to its permanent establishment in the other Contracting State as well as to the part of it in its home State which is dealing with the permanent establishment; for this reason, paragraph 6 gives an assurance of continuous and consistent tax treatment."

Paragraph 6

This paragraph reproduces article 7, paragraph 7, of the OECD Model Convention. The commentary on that paragraph is therefore relevant to article 7, paragraph 6, of the United Nations Model Convention. The commentary reads as follows:

"Although it has not been found necessary in the Convention to define the term 'profits', it should nevertheless be understood that the term when used in this Article and elsewhere in the Convention has a broad meaning including all income derived in carrying on an enterprise. Such a broad meaning corresponds to the use of the term made in the tax laws of most OECD Member countries.

"This interpretation of the term profits, however, may give rise to some uncertainty as to the application of the Convention. If the profits of an enterprise include categories of income which are treated separately in other articles of the Convention, e.g. [p. 96] dividends, it may be asked whether the taxation of those profits is governed by the special Article on dividends etc., or by the provisions of this Article.

"To the extent that an application of this Article and the special Article concerned would result in the same tax treatment, there is little practical significance to this question. Further, it should be noticed that some of the special Articles contain specific provisions giving priority to a specific article (cf. paragraph 4 of Article 6, paragraph 4 of Articles 10 and 11, paragraph 3 of Article 12 and paragraph 2 of Article 21).

"It has seemed desirable, however, to lay down a rule of interpretation in order to clarify the field of application of the present Article in relation to the other Articles dealing with a specific category of income. In conformity with the practice generally adhered to in existing bilateral conventions, paragraph 7 gives first preference to the special Articles on dividends interest etc. It follows from the rule that this article will be applicable to industrial and commercial income which does not belong to categories of income covered by the special articles, and, in addition, to dividends, interest etc. which under paragraph 4 of Articles 10 and 11, paragraph 3 of Article 12

and paragraph 2 of Article 21 fall within this article. It is understood that the items of income covered by the special Articles may, subject to the provisions of the Convention, be taxed either separately, or as industrial and commercial profits, in conformity with the tax laws of the Contracting States.

"It is open to Contracting States to agree bilaterally upon special explanations or definitions concerning the term 'profits' with a view to clarifying the distinction between this term and e.g. the concept of dividends. It may in particular be found appropriate to do so where in a convention under negotiation a deviation has been made from the definitions in the special Articles on dividends, interest and royalties. It may also be deemed desirable if the Contracting States wish to place on notice, that, in agreement with the domestic tax laws of one or both of the States, the term 'profits' includes special classes of receipts such as income from the alienation or the letting of a business or of movable property used in a business. In this connexion it may have to be considered whether it would be useful to include also additional rules for the allocation of such special profits."

C. OBSERVATIONS ON THE OECD COMMENTARY AND RESERVATIONS ON ARTICLE 7 OF THE OECD MODEL CONVENTION

Observations on the commentary

"*Australia and New Zealand* would wish to be free to propose in bilateral negotiations a provision to the effect that, if the [p. 97] information available to the competent authority of a Contracting State is inadequate to determine the profits to be attributed to the permanent establishment of an enterprise, the competent authority may apply to that enterprise for that purpose the provisions of the taxation law of that State, subject to the qualification that such law will be applied, so far as the information available to the competent authority permits, in accordance with the principles of this Article.

"*Australia* would wish that in this Article there be provision that will permit resort to domestic law in relation to the taxation of the profit of an insurance enterprise.

"While *New Zealand*, for the purpose of negotiating conventions with other Member countries, accepts, in general, the principles of this Article relating to the attribution of profits to a permanent establishment, it would wish to be free to negotiate for the inclusion of specific provision governing the basis of attribution in some particular situations."

Reservations on the article

"*New Zealand* reserves the right to exclude from the scope of this Article income from the business of any form of insurance.

"The *United States* believes it appropriate to provide in paragraph 2 for arm's length treatment not only with the head office of the enterprise, but also with any person controlling, controlled by, or subject to the same common control as, the enterprise. This can be accomplished by changing the phrase 'separate enterprise' to 'independent enterprise' and by deleting the last fourteen words."

* * *

[p. 105] *Article 9*

ASSOCIATED ENTERPRISES

A. GENERAL CONSIDERATIONS

Article 9 of the United Nations Model Convention reproduces article 9 of the OECD Model Convention.

This article deals with associated enterprises, i.e., parent and subsidiary companies and companies under common control. It should be considered in conjunction with article 25 on mutual agreement procedure and article 26 on exchange of information, just as article 9 of the OECD Model Convention has to be considered with articles 25 and 26 of that Convention.

The application of the arm's-length rule to the allocation of profits between the home office and its permanent establishment [p. 106] presupposes for most countries that the domestic legislation authorizes a determination on the basis of the arm's-length principle.

B. COMMENTARY ON THE PARAGRAPHS OF ARTICLE 9

Paragraph 1

Under this paragraph, as under article 9, paragraph 1, of the OECD Model Convention, the tax authorities of a Contracting State may, for the purpose of calculating tax liabilities, in the words of the OECD commentary on that paragraph "re-write the accounts of the enterprises if as a result of the special relations between the enterprises the accounts do not show the true taxable profits arising in that State". After observing that "it is evidently appropriate that adjustment should be sanctioned in such circumstances", the commentary states: "It should perhaps be mentioned that the provisions of this paragraph apply only if special conditions have been made or imposed between the two enterprises. No re-writing of the accounts of associated enterprises is authorised if the transactions between such enterprises have taken place on normal open market commercial terms (on an arm's-length basis)."

Paragraph 2

In the words of the commentary on article 9, paragraph 2, of the OECD Model Convention, "The re-writing of transactions between associated enterprises in the situation envisaged in paragraph 1 may give rise to economic double taxation (taxation of the same income in the hands of different person), in so far as an enterprise of State A whose profits are revised upwards will be liable to tax on an amount of profit which has already been taxed in the hands of its associated enterprise in State B." The OECD commentary observes that "paragraph 2 provides that in these circumstances, State B shall make an appropriate adjustment so as to relieve the double taxation". The remainder of the commen-

tary on article 9, paragraph 2, of the OECD Model Convention reads as follows:

"It should be noted, however, that an adjustment is not automatically to be made in State B simply because the profits in State A have been increased; the adjustment is due only if State B considers that the figure of adjusted profits correctly reflects what the profits would have been if the transactions had been at arm's length. In other words, the paragraph does not seek to avoid a double charge to tax which arises where the profits of one associated enterprise are increased to a level which exceeds what they would have been if they had been correctly computed on an arm's-length basis. State B is therefore committed to make an adjustment of the profits of the affiliated company only if it [p. 107] considers that the adjustment made in State A is justified both in principle and as regards the amount.

"The paragraph does not specify the method by which an adjustment is to be made. OECD Member countries use different methods to provide relief in these circumstances and it is therefore left open for Contracting States to agree bilaterally on any specific rules which they wish to add to the Article. Some States, for example, would prefer the system under which, where the profits of enterprise X in State A are increased to what they would have been on an arm's length basis, the adjustment would be made by re-opening the assessment on the associated enterprise Y in State B containing the doubly taxed profits in order to reduce the taxable profit by an appropriate amount. Some other States, on the other hand, would prefer to provide that, for the purposes of article 23, the doubly taxed profits should be treated in the hands of enterprise Y of State B as if they may be taxed in State A; accordingly, the enterprise of State B is entitled to relief in State B, under Article 23, in respect of tax paid by its associate enterprise in State A.

"It is not the purpose of the paragraph to deal with what might be called 'secondary adjustments'. Suppose that an upward revision of taxable profits of enterprise X in State A has been made in accordance with the principle laid down in

paragraph 1; and suppose also that an adjustment is made to the profits of enterprise Y in State B in accordance with the principle laid down in paragraph 2. The position has still not been restored exactly to what it would have been had the transactions taken place at arm's-length prices because, as a matter of fact, the money representing the profits which are the subject of the adjustment is found in the hands of enterprise Y instead of in those of enterprise X. It can be argued that if an arm's-length pricing had operated and enterprise X had subsequently wished to transfer these profits to enterprise Y, it would have done so in the form of, for example, a dividend or a royalty (if enterprise Y were the parent of enterprise X) or in the form of, for example, a loan (if enterprise X were the parent of enterprise Y); and that in those circumstances there could have been other tax consequences (e.g. the operation of a withholding tax) depending upon the type of income concerned and the provisions of the article dealing with such income.

"These secondary adjustments, which would be required to establish the situation exactly as it would have been if transactions had been at arm's length, depend on the facts of the individual case. It should be noted that nothing in paragraph 2 prevents such secondary adjustments from being made where they are permitted under the domestic laws of Contracting States.

[p. 108] "The paragraph also leaves open the question whether there should be a period of time after the expiration of which State B would not be obliged to make an appropriate adjustment to the profits of enterprise Y following an upward revision of the profits of enterprise X in State A. Some States consider that State B's commitment should be open-ended — in other words, that however many years State A goes back to revise assessments, enterprise Y should in equity be assured of an appropriate adjustment in State B. Other States consider that an open-ended commitment of this sort is unreasonable as a matter of practical administration. In the circumstances, therefore, this problem has not been dealt with in the text of the Article; but Contracting States are left free in bilateral conventions to include, if they wish, provisions dealing with the

length of time during which State B is to be under obligation to make an appropriate adjustment.

"If there is a dispute between the interested parties over the character and amount of the appropriate adjustment, the matter will be dealt with in the same way as any other question of fact; if necessary the competent authorities may consult each other."

C. OBSERVATIONS ON THE OECD COMMENTARY AND RESERVATIONS ON ARTICLE 9 OF THE OECD MODEL CONVENTION

Observations on the commentary

"In negotiating conventions with other Member countries, *Australia* and *New Zealand* would wish to be free to propose a provision to the effect that, if the information available to the competent authority of a Contracting State is inadequate to determine the profits to be attributed to an enterprise, the competent authority may apply to that enterprise for that purpose the provisions of the taxation law of that State, subject to the qualification that such law will be applied, as far as the information available to the competent authority permits, in accordance with the principles of this Article.

"*Australia* would wish that, in this Article, there be provision that will permit resort to domestic law in relation to the taxation of the profits of an insurance enterprise."

Reservations on the article

"*Belgium, Finland, Germany, Italy, Japan, Portugal* and *Switzerland* reserve the right not to insert paragraph 2 in their conventions.

"The *United States* believes that this Article should apply to all related persons, not just an enterprise of one Contracting State [p. 109] and a related enterprise of the other Contracting State, and that it should apply to 'income, deductions, credits or allowances', not just to 'profits'."

* * *

[p. 207] Commentaries on chapter VI

SPECIAL PROVISIONS

Article 24

NON-DISCRIMINATION

A. GENERAL CONSIDERATIONS

Article 24 of the United Nations Model Convention reproduces article 24 of the OECD Model Convention.

B. COMMENTARY ON THE PARAGRAPHS OF ARTICLE 24

Paragraph 1

Since this paragraph reproduces article 24, paragraph 1, of the OECD Model Convention, the commentary on that paragraph is fully relevant:

"This paragraph establishes the principle that for purposes of taxation discrimination on the grounds of nationality is forbidden, and that, subject to reciprocity, the nationals of a Contracting State may not be less favourably treated in the other Contracting State than nationals of the latter State in the same circumstances.

"It is noteworthy that the principle of non-discrimination, under various descriptions and with a more or less wide scope, was applied in international fiscal relations well before the appearance, at the end of the 19th Century, of the classic type of double taxation conventions. Thus, in a great many agreements of different kinds (consular or establishment conventions, treaties of friendship or commerce, etc.) concluded by States, especially in the 19th Century, in order to extend and strengthen the diplomatic protection of their nationals wherever resident, there are clauses under which each of the two Contracting States undertakes to accord nationals of the other State equality of treatment with their own nationals. The fact such clauses subsequently found their way into double taxation conventions has in no way affected their original justification and scope. The text of paragraph 1 provides that the application

of this paragraph is not restricted by article 1 to nationals solely who are residents of a Contracting State, but on the contrary, extends to all nationals of each Contracting State, whether or not they be residents of one [p. 208] of them. In other words, all nationals of a Contracting State are entitled to invoke the benefit of this provision as against the other Contracting State. This holds good, in particular, for nationals of the Contracting States who are not residents of either of them but of a third State.

"The expression 'in the same circumstances' refers to taxpayers (individuals, legal persons, partnerships and associations) placed, from the point of view of the application of the ordinary taxation laws and regulations, in substantially similar circumstances both in law and in fact.

"Consequently if a Contracting State, in giving relief from taxation on account of family responsibilities, distinguishes between its own nationals according to whether they reside in its territory or not, that State cannot be obliged to give nationals of the other State who do not reside in its territory the same treatment as it gives its resident nationals but it undertakes to extend to them the same treatment as is available to its non-resident nationals.

"Likewise, the provisions of paragraph 1 are not to be construed as obliging a State which accords special taxation privileges to its own public bodies or services as such, to extend the same privileges to the public bodies and services of the other State.

"Neither are they to be construed as obliging a State which accords special taxation privileges to private institutions not for profit whose activities are performed for purposes of public benefit, which are specific to that State to extend the same privileges to similar institutions whose activities are not for its benefit.

"To take the first of these two cases, if a State accords immunity from taxation to its own public bodies and services, this is justified because such bodies and services are integral parts of the State and at no time can their circumstances be

comparable to those of the public bodies and services of the other State. Nevertheless, this reservation is not intended to apply to State corporations carrying on gainful undertakings. To the extent that these can be regarded as being on the same footing as private industrial and commercial undertakings, the provisions of paragraph 1 will apply to them.

"As for the second case, if a State accords taxation privileges to certain private institutions not for profit, this is clearly justified by the very nature of these institutions' activities and by the benefit which that State and its nationals will derive from those activities.

"Furthermore, paragraph 1 has been deliberately framed in a negative form. By providing that the nationals of a Contracting [p. 209] State may not be subjected in the other Contracting State to any taxation or any requirement connected therewith which is other or more burdensome than the taxation and connected requirements to which nationals of the other Contracting State in the same circumstances are or may be subjected, this paragraph has the same mandatory force as if it enjoined the Contracting States to accord the same treatment to their respective nationals. But since the principal object of this clause is to forbid discrimination in one State against the nationals of the other, there is nothing to prevent the first State from granting to persons of foreign nationality, for special reasons of its own, or in order to comply with a special stipulation in a double taxation convention, such as, notably, the requirement that profits of permanent establishments are to be taxed on the basis of separate accounts, certain concessions or facilities which are not available to its own nationals. As it is worded, paragraph 1 would not prohibit this.

"Subject to the foregoing observation, the words '. . . shall not be subjected . . . to any taxation or any requirement connected therewith which is other or more burdensome . . .' mean that when a tax is imposed on nationals and foreigners in the same circumstances, it must be in the same form as regards both the basis of charge and the method of assessment, its rate must be the same and, finally, the formalities connected with

the taxation (returns, payment, prescribed times, etc.) must not be more onerous for foreigners than for nationals."

Paragraph 2

Since this paragraph reproduces article 24, paragraph 2, of the OECD Model Convention, the commentary on that paragraph is fully relevant:

"Paragraph 2 merely stipulates that the term 'nationals' applies to all individuals possessing the nationality of a Contracting State. It has not been judged necessary here to introduce into the text of the article any considerations on the signification of the concept of nationality, any more than it seemed indispensable to make any special comment here on the meaning and application of the word. Obviously, in determining in relation to individuals, what is meant by 'the nationals of a Contracting State', reference must be made to the sense in which the term is usually employed and each State's particular rules on the acquisition or loss of nationality.

"But paragraph 2 is more specific as to legal persons, partnerships and associations. By declaring that all legal persons, partnerships and associations deriving their status as such from the laws in force in a Contracting State are considered to be nationals for the purposes of paragraph 1, the provision disposes [p. 210] of a difficulty which often arises in determining the nationality of companies. In defining the nationality of companies, certain States have regard less to the law which governs the company than to the origin of the capital with which the company was formed or the nationality of the individuals or legal persons controlling it.

"Moreover, in view of the legal relationship created between the company and the State under whose law it is constituted, which from certain points of view is closely akin to the relationship of nationality in the case of individuals, it seems justifiable not to deal with legal persons, partnerships and associations in a special provision, but to assimilate them with individuals under the term 'nationals'."

Paragraph 3

Since this paragraph reproduces article 24, paragraph 3, of the OECD Model Convention, the commentary on the latter paragraph, which reads as follows, is fully relevant:

"On 28th September, 1954, a number of States concluded in New York a Convention relating to the status of stateless persons, under article 29 of which stateless persons must be accorded national treatment. The signatories of the Convention include several OECD Member countries.

"It should, however, be recognized that the provisions of paragraph 3 will, in a bilateral convention, enable national treatment to be extended to stateless persons who, because they are in one of the situations enumerated in paragraph 2 of article 1 of the above-mentioned Convention of 28th September, 1954, are not covered by that Convention. This is mainly the case, on the one hand, of persons receiving at the time of signature of that Convention, protection or assistance from organs or agencies of the United Nations other than the United Nations High Commissioner for Refugees, and, on the other hand, of persons who are residents of a country and who there enjoy and are subject to the rights and obligations attaching to the possession of that country's nationality.

"The purpose of paragraph 3 is to limit the scope of the clause concerning equality of treatment with nationals of a Contracting State solely to stateless persons who are residents of that or the other Contracting State.

"By thus excluding stateless persons who are residents of neither Contracting State, such a clause prevents their being privileged in one State as compared with nationals of the other state.

"However, if States were to consider it desirable in their [p. 211] bilateral relations, to extend the application of paragraph 3 to all stateless persons, whether residents of a Contracting State or not, so that in all cases they enjoy the most favourable treatment accorded to nationals of the State concerned, in order to do this they would need only to adopt the

following text which contains no condition as to residence in a Contracting State:

" 'Notwithstanding the provisions of Article 1, stateless persons shall not be subjected in a Contracting State to any taxation or any requirement connected therewith which is other or more burdensome than the taxation and connected requirements to which nationals of that State in the same circumstances are or may be subjected'.

"It is possible that in the future certain States will take exception to the provisions of paragraph 3 as being too liberal insofar as they entitle stateless persons who are residents of one State to claim equality of treatment not only in the other State but also in their State of residence and thus benefit in particular in the latter from the provisions of double taxation conventions concluded by it with third States. If such States wished to avoid this latter consequence, they would have to modify paragraph 3 as follows:

" 'Stateless persons who are residents of a Contracting State shall not be subjected in the other Contracting State to any taxation or any requirement connected herewith which is other or more burdensome than the taxation and connected requirements to which nationals of that other State in the same circumstances are or may be subjected.'

"Finally, it should be understood that the definition of the term 'stateless person' to be used for the purposes of such a clause can only be that laid down in paragraph 1 of Article 1 of the Convention of 28th September, 1954, which defines a stateless person as 'a person who is not considered as a national by any State under the operation of its law'."

Paragraph 4

Since this paragraph reproduces article 24, paragraph 4, of the OECD Model Convention, the commentary on that paragraph is fully relevant:

"Strictly speaking, the type of discrimination which this paragraph is designed to end is discrimination based not on

nationality but on the actual situs of an enterprise. It therefore affects without distinction, and irrespective of their nationality, all residents of a Contracting State who have a permanent establishment in the other Contracting State.

"It appears necessary first to make it clear that the wording [p. 212] of the first sentence of paragraph 4 must be interpreted in the sense that it does not constitute discrimination to tax non-resident persons differently, for practical reasons, from resident persons, as long as this does not result in more burdensome taxation for the former than for the latter. In the negative form in which the provision concerned has been framed, it is the result alone which counts, it being permissible to adapt the mode of taxation to the particular circumstances in which the taxation is levied.

"By the terms of the first sentence of paragraph 4, the taxation of a permanent establishment shall not be less favourably levied in the State concerned than the taxation levied on enterprises of that State carrying on the same activities. The purpose of this provision is to end all discrimination in the treatment of permanent establishments as compared with resident enterprises belonging to the same sector of activities, as regards taxes based on industrial and commercial activities, and especially taxes on business profits.

"However, the second sentence of paragraph 4 specifies the conditions under which the principle of equal treatment set forth in the first sentence should be applied to individuals who are residents of a Contracting State and have a permanent establishment in the other State. It is designed mainly to ensure that such persons do not obtain greater advantages than residents, through entitlement to personal allowances and reliefs for family responsibilities, both in the State of which they are residents, by the application of its domestic laws, and in the other State by virtue of the principle of equal treatment. Consequently, it leaves it open to the State in which the permanent establishment is situated whether or not to give personal allowances and reliefs to the persons concerned in the proportion which the amount of the permanent establishment's profits bears to the world income taxable in the other State.

"As regards the first sentence, experience has shown that it was difficult to define clearly and completely the substance of the principle of equal treatment and this has led to wide differences of opinion with regard to the many implications of this principle. The main reason for difficulty seems to reside in the actual nature of the permanent establishment which is not a separate legal entity but only a part of an enterprise that has its head office in another State. The situation of the permanent establishment is different from that of a domestic enterprise, which constitutes as single entity all of whose activities, with their fiscal implications, can be fully brought within the purview of the State where it has its head office. The implications of the equal treatment clause will be examined below under several aspects of the levying of tax.

[p. 213] "*A. Assessment of tax*

"With regard to the basis of assessment of tax, the principle of equal treatment normally has the following implications:

"(*a*) Permanent establishments must be accorded the same right as resident enterprises to deduct the trading expenses that are, in general, authorized by the taxation law to be deducted from taxable profits in addition to the right to attribute to the permanent establishment a proportion of the overheads of the head office of the enterprise. Such deductions should be allowed without any restrictions other than those also imposed on resident enterprises.

"(*b*) Permanent establishments must be accorded the same facilities with regard to depreciation and reserves. They should be entitled to avail themselves without restriction not only of the depreciation facilities which are customarily available to enterprises (straight line depreciation, declining balance depreciation), but also of the special systems that exist in a number of countries ('wholesale' writing down, accelerated depreciation, etc.). As regards reserves, it should be noted that these are sometimes authorised for purposes other than the offsetting — in accordance with commercial accounting principles — of depreciation on assets, expenses or losses which have not yet

occurred but which circumstances make likely to occur in the near future. Thus, in certain countries, enterprises are entitled to set aside, out of taxable profit provisions or 'reserves' for investment. When such a right is enjoyed by all enterprises, or by all enterprises in a given sector of activity, it should normally also be enjoyed, under the same conditions, by non-resident enterprises, or by all enterprises in a given sector of activity, it should in the State concerned insofar, that is, as the activities to which such provisions or reserves would pertain are taxable in that State.

"(*c*) Permanent establishments should also have the option that is available in most countries to resident enterprises of carrying forward or backward a loss brought out at the close of an accounting period within a certain period of time (e.g. 5 years). It is hardly necessary to specify that in the case of permanent establishments it is the loss on their own business activities, as shown in the separate accounts for these activities, which will qualify for such carry-forward.

"(*d*) Permanent establishments should further have the same rules applied to resident enterprises, with regard to the taxation of capital gains realised on the alienation of assets, whether during or on the cessation of business.

"Although the general rules mentioned above rarely give rise to any difficulties with regard to the principle of nondiscrimination, the same does not always hold good for the tax [p. 214] incentive measures which most countries, faced with such problems as decentralization of industry, development of economically backward regions, or the promotion of new activities necessary for the expansion of the economy, have introduced in order to facilitate the solution of these problems by means of tax exemptions, reductions or other tax advantages given to enterprises for investment which is in line with official objectives.

"As such measures are in furtherance of objectives directly related to the economic activity proper of the State concerned, it is right that the benefit of them should be extended to permanent establishments of enterprises of another State which

has a double taxation convention with the first embodying the provisions of Article 24, once they have been accorded the right to engage in industrial or commercial activity in that State, either under its legislation or under an international agreement (treaties of commerce, establishment conventions, etc.) concluded between the two States.

"It should, however, be noted that although non-resident enterprises are entitled to claim these tax advantages in the State concerned, they must fulfil the same conditions and requirements as resident enterprises. They may, therefore, be denied such advantages if their permanent establishments are unable or refuse to fulfil the special conditions and requirements attached to the granting of them.

"Finally, it goes without saying that non-resident enterprises are not entitled to tax advantages attaching to activities the exercise of which is strictly reserved, on grounds of national interest, defence, protection of the national economy, etc., to domestic enterprises, since non-resident enterprises are not allowed to engage in such activities.

"B. Special treatment of dividends received in respect of holdings owned by permanent establishments

"In many countries special rules exist for the taxation of dividends distributed between companies (parent company-subsidiary treatment, the 'Schachtelprivileg', the rule 'non bis in idem'). The question arises whether such treatment should by effect of the provisions of paragraph 4 also be enjoyed by permanent establishments in respect of dividends on holdings forming part of their assets.

"On this point opinions differ. Some States consider that such special treatment should be accorded to permanent establishments. They take the view that such treatment was enacted in order to avoid double taxation on profits made by a subsidiary and distributed to a parent company. In principle profits tax [p. 215] should be levied once, in the hands of the subsidiary performing the profit-generating activities. The parent company should be exempted from tax on such profits when received

from the subsidiary or should, under the indirect credit method, be given relief for the taxation borne by the subsidiary. In cases where shares are held as direct investment by a permanent establishment the same principle implies that such a permanent establishment receiving dividends from the subsidiary should likewise be granted the special treatment in view of the fact that a profits tax has already been levied in the hands of the subsidiary. On the other hand, it is hardly conceivable on this line of thought to leave it to the State where the head office of the parent company is situated to give relief from double taxation brought about by a second levying of tax in the State of the permanent establishment. The state of the parent company, in which no activities giving rise to the doubly taxed profits have taken place, will normally exempt the profits in question or will levy a profits tax which is not sufficient to bear a double credit (i.e. for the profits tax on the subsidiary as well as for such tax on the permanent establishment). All this assumes that the shares held by the permanent establishment are effectively connected with its activity. Furthermore, an obvious additional condition is that the profits out of which the dividends are distributed should have borne a profits tax.

"Other States, on the contrary, consider that assimilating permanent establishments to their own enterprises does not entail any obligation to accord such special treatment to the former. They justify their position on various grounds. The purpose of such special treatment is to avoid economic double taxation of dividends and it should be for the recipient company's State of residence and not the permanent establishment's State to bear its cost, because it is more interested in the aim in view. Another reason put forward related to the sharing of tax revenue between States. The loss of tax revenue incurred by a State in applying such special treatment is partly offset by the taxation of the dividends when they are redistributed by the parent company which has enjoyed such treatment (withholding tax on dividends, shareholder's tax). A State which accorded such treatment to permanent establishments would not have the benefit of such a compensation. Another argument made is that when such treatment is made conditional upon redistribution of the dividends its extension to permanent

establishments would not be justified, for in such a case the permanent establishment, which is only a part of a company of another State and does not distribute dividends, would be more favourably treated than a resident company. Finally, the States which feel that paragraph 4 does not entail any obligation to extend such treatment to permanent establishments [p. 216] argue that there is a risk that companies of one State might transfer their holdings in companies of another State to their permanent establishments in that other State for the sole purpose of availing themselves of such treatment.

"The fact remains that there can be very valid reasons for a holding being owned and managed by a permanent establishment rather than by the head office of the enterprise, viz.,

"— reasons of necessity arising principally from a legal or regulatory obligation on banks and financial institutions and insurance companies to keep deposited in countries where they operate a certain amount of assets, particularly shares, as security for the performance of their obligations;

"— or reasons of expediency, where the holdings are in companies which have business relations with the permanent establishment or whose head offices are situated in the same country as the permanent establishment;

"— or simple reason of practical convenience, in line with the present tendency towards decentralization of management functions in large enterprises.

"In view of these divergent attitudes, as well as of the existence of the situations just described, it would be advisable for States, when concluding bilateral conventions, to make clear the interpretation they give to the first sentence of paragraph 4. They can, if they so desire, explain their position, or change it as compared with their previous practice, in a protocol or any other document annexed to the convention.

"A solution could also be provided in such a document to meet the objection mentioned above that the extension of the treatment of holdings in a State (A) to permanent establishments of companies which are residents of another State (B)

results in such companies unduly enjoying privileged treatment as compared with other companies which are residents of the same State and whose head offices own holdings in the capital of companies which are residents of State A, in that whereas the dividends on their holdings can be repatriated by the former companies without bearing withholding tax, such tax is levied on dividends distributed to the latter companies at the rate of 5 or 15 per cent as the case may be. Tax neutrality and the equality of tax burdens as between permanent establishments and subsidiary companies, as advocated by the States concerned, could be ensured by adapting, in the bilateral convention between States A and B, the provisions of paragraphs 2 and 4 or Article 10, so as to enable withholding tax to be levied in State A on dividends paid by companies which are residents of that State to permanent establishments of companies which are residents of State B in the [p. 217] same way as if they are received directly, i.e. by the head offices of the latter companies, viz., at the rate of:

"— 5 per cent in the case of a holding of at least 25 per cent;

"— 15 per cent in all other cases.

"Should it not be possible, because of the absence of appropriate provisions in the domestic laws of the State concerned, to levy a withholding tax there on dividends paid to permanent establishments, the treatment of inter-company dividends could be extended to permanent establishments, as long as its application is limited in such manner that the tax levied by the State of source of the dividends is the same whether the dividends are received by a permanent establishment of a company which is a resident of the other State or are received directly by such a company.

"C. Structure and rate of tax

"In countries where enterprises, mainly companies, are charged a tax on their profits which is specific to them, the provisions of paragraph 4 raise, with regard to the rate applicable in the case of permanent establishments, especially difficult and delicate problems, which here too arise from the fact that

the permanent establishment is only a part of legal entity which is not under the jurisdiction of the State where the permanent establishment is situated.

"When the taxation of profits made by companies which are residents of a given State is calculated according to a progressive scale of rates, such a scale should, in principle, be applied to permanent establishments situated in that State. If in applying the progressive scale, the permanent establishment's State takes into account the profits of the whole company to which such a permanent establishment belongs, such a rule would not appear to conflict with the equal treatment rule, since resident companies are in fact treated in the same way. States that tax their own companies in this way could therefore define in their bilateral conventions the treatment applicable to permanent establishments.

"When a system of taxation based on a progressive scale of rates includes a rule that a minimum rate is applicable to permanent establishments, it cannot be claimed a priori that such a rule is incompatible with the equal treatment principle. The profits of the whole enterprise to which the permanent establishment belongs should be taken into account in determining the rate applicable according to the progressive scale. The provisions of the first sentence of paragraph 4 are not observed only if the minimum rate is higher.

[p. 218] "However, even if the profits of the whole enterprise to which the permanent establishment belongs is taken into account when applying either a progressive scale of rates or a minimum rate, this should not conflict with the principle of the distinct and separate enterprise, according to which the profits of the permanent establishment must be determined under paragraph 2 of article 7. The minimum amount of the tax levied in the State where the permanent establishment is situated is, therefore, the amount which would be due if it were a distinct and separate enterprise, without reference to the profits of the whole enterprise to which it belongs. The State where the permanent establishment is situated is, therefore, justified in applying the progressive scale applicable to resident enterprises solely to the profits of the permanent establishment,

leaving aside the profits of the whole enterprise when the latter are less than those of the permanent establishment. This State may likewise tax the profits of the permanent establishment at a minimum rate, provided that the same rate applies also to resident enterprises, even if taking into account the profits of the whole enterprise to which it belongs would result in a lower amount of tax, or no tax at all.

"As regards the split-rate system of company tax, it should first be pointed out as being a fact central to the issue here that most OECD Member countries which have adopted this system do not consider themselves bound by the provisions of paragraph 4 to extend it to permanent establishments of non-resident companies. This attitude is based, in particular, on the view that the split rate is only one element amongst others (in particular a withholding tax on distributed income) in a system of taxing company profits and dividends which must be considered as a whole and is therefore, both for legal and technical reasons, of domestic application only. The State where the permanent establishment is situated could claim the right not to tax such profits at the reduced rate, as generally, it does not tax the dividends distributed by the company to which the permanent establishment belongs. Moreover, a State which has adopted a split-rate system usually has other economic policy objectives, such as the promotion of the capital market, by encouraging resident companies to distribute dividends. The extension of the reduced rate to the profits of the permanent establishment would not serve such a purpose at all, as the company distributing the dividends is not a resident of the State concerned.

"This view is, however, disputed. The States in favour of extending the split-rate system to permanent establishments urge that as the essential feature of this system is a special technique of taxing profits which enterprises in a corporate form derive [p. 219] from their activities, and is designed to afford immediate relief from the double taxation levied on the profits distributed, it should be applied to permanent establishments in bilateral conventions against double taxation. It is generally recognised that, by the effects of their provisions,

such conventions necessarily result in some integration of the taxation systems of the Contracting States. On this account, it is perfectly conceivable that profits made in a State (A) by a permanent establishment of a company resident in another State (B) should be taxed in State A according to the split-rate system.

As a practical rule, the tax could in such case be calculated at the reduced rate (applicable to distributed profits) on that proportion of an establishment's profits which corresponds to the ratio between the profit distributed by the company to which it belongs and the latter's total profit; the remaining profit could be taxed at the higher rate. Of course, the two Contracting States would have to consult together and exchange all information necessary for giving practical effect to this solution. Similar considerations apply to systems where distributions of profits made can be deducted from the taxable income of a company.

"As regards the imputation system ('avoir fiscal' or 'tax credit'), it seems doubtful, at least on a literal interpretation of the provisions of paragraph 4, whether it should be extended to non-resident companies in respect of dividends paid out of profits made by their permanent establishment. In fact, it has identical effects to those of the split-rate system but these effects are not immediate as they occur only at the time of the shareholder's personal taxation. From a purely economic and financial standpoint, however, it is conceivable that such profits should be treated as though they were profits of a district company in State A where the permanent establishment of a company which is a resident of State B is situated, and, to the extent that they are distributed, carry the 'avoir fiscal' or 'tax credit'. But to take the matter further, to avoid all discrimination it is necessary that this advantage should already have been accorded to shareholders who are residents of State B of companies which are residents of State A. From the practical standpoint, the two States concerned should, of course, agree upon the conditions and procedures for allowing the 'avoir fiscal' or 'tax credit' to shareholders who are themselves residents of either State, of the companies concerned that are residents of State B.

"Contracting States which are faced with the problems described above may settle them in bilateral negotiations in the light of their peculiar circumstances.

[p. 220] *"D. Withholding tax on dividends, interest and royalties received by a permanent establishment*

"When permanent establishments receive dividends, interest or royalties such income, by virtue of paragraph 4 of Articles 10 and 11 and paragraph 3 of Article 12, respectively, comes under the provisions of Article 7 and consequently — subject to the observations made . . . as regards dividends received on holdings of permanent establishment — falls to be included in the taxable profits of such permanent establishments.

"According to the respective Commentaries on the abovementioned provisions of Articles 10, 11 and 12 these provisions dispense the State of source of the dividends, interest or royalties received by the permanent establishment from applying any limitation provided for in those Articles, which means — and this is the generally accepted interpretation — that they leave completely unaffected the right of the State of source, where the permanent establishment is situated, to apply its withholding tax at the full rate.

"While this approach does not create any problems with regard to the provisions of paragraph 4 of article 24 in the case of countries where a withholding tax is levied on all such income, whether the latter be paid to residents (permanent establishments, like resident enterprises, being allowed to set such withholding tax off against the tax on profits due by virtue of Article 7) or to non-residents (subject to the limitations provided for in Articles 10, 11 and 12), the position is different when withholding tax is applied exclusively to income paid to non-residents.

"In this latter case, in fact, it seems difficult to reconcile the levy of withholding tax with the principle set out in paragraph 4

that for the purpose of taxing the income which is derived from their activity or which is normally connected with it — as is recognized to be the case with dividends, interest and royalties referred to in paragraph 4 of Articles 10 and 11 and in paragraph 3 of Article 12 — permanent establishments must be treated as resident enterprises and hence in respect of such income be subjected to tax on profits solely.

"In any case, it is for Contracting States which have this difficulty to settle it in bilateral negotiations in the light of their peculiar circumstances.

"*E. Credit for foreign tax*

"In a related context, when a permanent establishment receives foreign income which is included in its taxable profits, it is right by virtue of the same principle to grant to the permanent [p. 221] establishment credit for foreign tax borne by such income when such credit is granted to resident enterprises under domestic laws.

"If in a Contracting State (A) in which is situated a permanent establishment of an enterprise of the other Contracting State (B) credit for tax levied in a third State (C) can be allowed only by virtue of a convention, then the more general question arises, as to the extension to permanent establishments of the benefit of conventions concluded with third States . . . .

"It should, however, be pointed out that difficulties may arise as to the amount of the credit to be allowed, if permanent establishments in State A benefit from the convention which State B has concluded with State C. Such amount may be either the amount of tax effectively collected by State C or the amount of tax which State C may collect by virtue either of its convention with State A or its convention with State B. Moreover, the question arises whether such credit is not given twice, i.e. once in State A, where the permanent establishment is situated, and again in State B, the State of residence. It is for Contracting States to settle such problems, if necessary, in their bilateral negotiations.

"*F. Extension to permanent establishments of the benefit of double taxation conventions concluded with third states*

"While an enterprise of a State (A) can normally claim, in respect of the permanent establishment which it possesses in another State (B), the benefit of the provisions of the convention between those two States A and B, it nevertheless cannot, should such permanent establishment derive income from a third State (C), invoke the provisions of the convention between States B and C for the benefit of such permanent establishment since it, the enterprise, is in fact resident of neither of those two States . . . This is the consequence of the well-known principle of the relative effect of treaties, which means that they have effect only as between the Contracting States.

"Nor could such an enterprise invoke for this purpose a most-favoured-nation clause, however general its terms, included in a treaty or agreement concluded between States A and B. In fact, it has always been accepted that such a clause did not apply in the case of double taxation conventions because these are essentially based on the principle of reciprocity. It should, however, be noted that some States have made provision in their double taxation conventions enabling the provisions of the latter to be applied 'in special cases', to permanent establishments of enterprises of a third State."

[p. 222] *Paragraph 5*

Since this paragraph reproduces article 24, paragraph 5, of the OECD Model Convention, the commentary on that paragraph is fully relevant:

"This paragraph is designed to end a particular form of discrimination resulting from the fact that in certain countries the deduction of interest, royalties and other disbursements allowed without restriction when the recipient is resident, is restricted or even prohibited when he is a non-resident. The same situation may also be found in the sphere of capital taxation, as regards debts contracted to a non-resident. It is however open to Contracting States to modify this provision in

bilateral conventions to avoid its use for tax avoidance purposes."

In the course of the discussion by the Group of Experts of paragraph 5 a question was raised whether such a paragraph was suitable for inclusion in a tax treaty between developed and developing countries. It was suggested that the paragraph would not be acceptable to those countries that made deductibility of disbursements made abroad by foreign-owned corporations conditional on the recipient being taxed in such countries. After substantial discussion, the feeling of the Group was that the special circumstances mentioned above ought not to be the basis for treaty articles of broad application but that in cases where they were likely to create a problem they should be raised in bilateral negotiations.

Paragraph 6

Since this paragraph reproduces article 24, paragraph 6, of the OECD Model Convention, the commentary on that paragraph is fully relevant:

> "This paragraph forbids a Contracting State to give less favourable treatment to an enterprise, the capital of which is owned or controlled, wholly or partly, directly or indirectly, by one or more residents of the other Contracting State. This provision, and the discrimination which it puts an end to, relates to the taxation only of enterprises and not of the persons owning or controlling their capital. Its object therefore is to ensure equal treatment for taxpayers residing in the same State, and not to subject foreign capital, in the hands of the partners or shareholders, to identical treatment to that applied to domestic capital."

In the course of the Group's discussion of paragraph 6, some members from developing countries proposed that special measures applicable to foreign-owned enterprises should not be construed as constituting prohibited discrimination as long as all foreign-owned enterprises were treated alike; they said that that change represented [p. 223] a notable departure from the general principle of taxing foreign persons on the same basis as nationals

but that the problems of tax compliance in cases in which foreign ownership was involved and the politically sensitive position of foreign-owned enterprises in developing countries warranted the change. Therefore, they proposed that article 24, paragraph 6, of the OECD Model Convention be amended to read as follows:

> "6. Enterprises of a Contracting State, the capital of which is wholly or partly owned or controlled, directly or indirectly, by one or more residents of the other Contracting State, shall not be subjected in the first-mentioned State to any taxation or any requirement connected therewith which is other or more burdensome than the taxation and connected requirements to which are subjected other similar enterprises *the capital of which is wholly or partly owned or controlled, directly or indirectly, by residents of third countries.*"

They went on to point out that the proposed change in paragraph 6 had been included in several tax treaties to which developed countries were parties. Some members from developed countries pointed out that such a proposal would in fact limit the effect of the non-discrimination article to the prevention of discrimination between enterprises owned by non-residents, thus leaving the door open to discrimination against enterprises owned by non-residents as a class.

Several members from developed countries expressed reservations concerning the proposed change and pointed out that they considered the OECD non-discrimination article as the backbone of the Convention. They recalled that the antecedents of the non-discrimination article in the present OECD Model Convention dated from the nineteenth century. They felt that if such a fundamental principle were to be altered, it would have a significant effect on international tax relations generally. Further, since the proposed change was motivated in part by problems with tax compliance where foreign ownership was involved — essentially, problems with transfer pricing — it was suggested that the problem might be dealt with more properly in other parts of the tax convention, such as in article 9 dealing with associated enterprises.

Some members from developing countries indicated that, while recognizing the essential importance of and need for the article on non-discrimination, some countries might wish to modify certain paragraphs of that article in bilateral negotiations. It was suggested for example that, because of the difficulties involved in determining what constituted reasonable amounts in the case of transfer payments on account of royalties, technical assistance fees, head office expenses and so on, a country might desire to deny deductions for such payments or compute the amount of deduction in accordance with the domestic law of the country when such payments were made by an [p. 224] enterprise situated within its territory to a foreign controlling company, whether the latter was resident in another Contracting State or in a third country. Another example cited was that of a country which granted tax preferences with a view to the attainment of certain national objectives which might wish to make a given percentage of local ownership of the enterprise involved a condition for the granting of such tax preferences. The Group recognized that special situations such as those mentioned as examples should be resolved in bilateral negotiations.

Paragraph 7

Since this paragraph reproduces article 24, paragraph 7, of the OECD Model Convention, the commentary on that paragraph is fully relevant:

> "This paragraph states that the scope of the article is not restricted by the provisions of article 2. The article therefore applies to taxes of every kind and description levied by, or on behalf of, the State, its political subdivisions or local authorities."

C. Observations on the OECD Commentary and Reservations on Article 26 of the OECD Model Convention

Observations on the commentary

"The interpretation given in paragraphs 40 and 41 above is not endorsed by *Germany*, the tax laws of which require the

application of a minimum rate with respect to non-residents. Under German tax laws, the profits of a permanent establishment of an enterprise operated in Germany by a non-resident individual are charged income tax at a minimum rate of 25 per cent. On the other hand, the German tax laws restrict the application of higher rates by strictly limiting the basis of determining the rate applicable to profits derived from German sources — thus excluding any profits derived by those parts of the enterprise which are situated abroad. Moreover, since the minimum rate of 25 per cent is close to the lower end of the progressive tax scale, which ranges from 22 per cent to 56 per cent, Germany is of the opinion that the application of the minimum rate of 25 per cent does not violate the provisions of paragraph 4.

"The *United States* observes that its non-resident citizens are not in the same circumstances as other non-residents, since the United States taxes its non-resident citizens on their worldwide income.

[p. 225] *Reservations on the article*

"*Australia, Canada* and *New Zealand* reserve their positions on this Article.

"*Paragraph* 1

"*France* accepts the provisions of paragraph 1 but wishes to reserve the possibility of granting only to French nationals the exemption, provided for in its domestic laws, of gains from the alienation of immovable property which constitutes, whether in whole or in part, the residence in France of French nationals who are domiciled abroad.

"The *United Kingdom* reserves its position on the second sentence of paragraph 1.

"*Paragraph* 4

"*Belgium* reserves the right to apply the provisions of its internal law for the purpose of taxing the profits of Belgian permanent establishments of companies and associations resident in countries with which it undertakes negotiations, when-

ever such an attitude is warranted by the general treatment accorded in such countries to permanent establishments of companies and associations resident in Belgium (paragraph 4).

"*Japan* reserves the right not to extend to the permanent establishments of non-residents the benefit of tax incentive measures introduced for national policy objectives.

"*Paragraph* 5

"*France* accepts the provisions of paragraph 5 but wishes to reserve the possibility of applying the provisions in its domestic laws relative to the limitation to the deduction of interest paid by a French company to a foreign parent company."

EXHIBIT 55

Senate Bill No. 85

CHAPTER 660

An act to add Chapter 1.9 (commencing with Section 15365), Chapter 6 (commencing with Section 15397), and Chapter 7 (commencing with Section 15398) to Part 6.7 of Division 3 of, and to add Article 12 (commencing with Section 16429.30) to Chapter 2 of Part 2 of Division 4 of, Title 2 of, the Government Code, to amend Sections 24274, 24344, 24348, 24667, and 24668 of, to amend and renumber Section 25110 of, to add Sections 24411 and 24670 to, and to add and repeal Article 1.5 (commencing with Section 25110) of Chapter 17 of Part II of Division 2 of, the Revenue and Taxation Code, relating to taxation.

[Approved by Governor September 5, 1986. Filed with Secretary of State September 5, 1986.]

LEGISLATIVE COUNSEL'S DIGEST

SB 85, Alquist. Bank and corporation taxes: unitary businesses.

(1) Existing law provides for the organization of corporations for specific purposes.

This bill would provide for the establishment of a nonprofit public benefit corporation to be known as the Small Business Bond Insurance Corporation. This bill would provide for the membership, compensation, duties, and powers of the corporation's board of directors.

The corporation would have the primary goal of increasing the availability of long-term financing to small businesses in California, and the primary method of accomplishing this goal would be through insurance or guarantees of the payment of bonds issued by or for the benefit of small businesses.

This bill would establish a California Small Business Bond Insurance Corporation Operations Fund in the State Treasury for the receipt of state, federal, and private moneys for the operating expenses of the corporation and would provide, upon appropriation by the Legislature, for the manner in which the moneys in the fund are to be disbursed.

This bill would establish a California Small Business Bond Insurance Reserve Fund in the State Treasury for the receipt of state, federal, and private moneys, returns on investments on these moneys, premiums charged by the corporation, and recoveries and collection on claims paid by the corporation. This bill would provide that the moneys in the fund are to be made available, upon appropriation by the Legislature, for purposes of the small business bond insurance programs conducted by the corporation.

(2) Existing law charges the California State World Trade Commission with encouraging international trade, tourism, and development.

This bill would create within the commission a California Office of Trade Policy to, among other things, support vigorous enforcement of trade laws against unfair foreign trade practices in United States markets.

This bill would also create within the commission the California Office of Export Promotion to, among other things, strengthen the state's activities in marketing its agricultural, manufacturing, and service industries overseas.

(3) Existing law creates various departments within the Business, Transportation and Housing Agency.

This bill would create within the agency a Development Review Panel, consisting of specified membership, to promote and assist economic development projects where additional development or expansion otherwise is not possible because of a lack of adequate funding for infrastructure. It would specify the powers and duties of this panel. It would provide that all moneys loaned to the panel that are required to be repaid shall be deposited in a specified fund.

(4) This bill would create in the State Treasury a California Unitary Fund, the moneys of which would be used exclusively for infrastructure financing and economic development. It would create the Future Infrastructure State Targeted Account and the Local Project Account for Non-Transient Spending in the California Unitary Fund. It would require the moneys in the California Unitary Fund to remain in the fund until appropriated by the Legislature and upon appropriation would require that moneys in the Future Infrastructure State Targeted Account be made available in specified percentages for specified purposes.

(5) Under the existing Bank and Corporation Tax Law, the income of a unitary business which is subject to taxation is determined by means of an apportionment formula based on income derived from or attributable to sources both within and without the state. That formula generally includes the use of 3 factors: payroll, property, and sales.

This bill would allow a qualified taxpayer, as defined, whose income is subject to the tax imposed under the Bank and Corporation Tax Law to determine its income derived from or attributable to sources within this state pursuant to a water's-edge election, as specified. This bill would require that a water's-edge election be made by contract with the Franchise Tax Board, as specified, for an initial term of 10 years and subject to annual renewal. It would provide for the method of terminating the election by written notice of nonrenewal by the taxpayer.

This bill would require that each contract provide for annual payments to be made by the taxpayer to the Franchise Tax Board for deposit in the California Unitary Fund, which this bill would create. This bill would require that of the amount of annual payments made by qualified taxpayers for deposit in the California Unitary Fund, ⅓ of that amount be deposited in the Local Project Account for Non-Transient Spending and ⅔ of that amount be deposited in the Future Infrastructure State Targeted Account.

This bill would also provide for various new administrative procedures in connection with the water's-edge election and would require the Franchise Tax Board to conduct a specified

study relating to certain auditing practices to be reported to the Legislature no later than March 1, 1987.

(6) Under the existing Bank and Corporation Tax Law, a taxpayer is generally entitled to deduct dividends received in computing its income subject to tax if the dividends were declared from income which has been included in the measure of taxes imposed under that law upon the taxpayer declaring the dividends. In the case of a unitary business, dividends received which are treated as nonbusiness income are entirely allocable to this state in computing the taxpayer's income if its commercial domicile is in this state, and dividends received which are treated as business income are subject to allocation and apportionment to this state under the unitary apportionment formula in computing the taxpayer's income.

This bill would permit a qualified taxpayer who elects to determine its income under a water's-edge election to deduct either 100% or 75% of specified portions of its qualifying dividends, as defined, which are received in accordance with specified formulas.

(7) Under the existing Bank and Corporation Tax Law, a taxpayer may take a deduction for debts which become wholly or partially worthless within the income year or for a reasonable addition to a reserve for bad debts. The amount of the deduction may be determined using either the specific charge-off method or the reserve method.

This bill would eliminate the availability of the reserve method of deducting bad debts for all taxpayers, other than savings and loan associations, banks, or financial corporations. It would also provide special transitional rules in connection with these changes.

Under the existing Bank and Corporation Tax Law, a dealer in real and tangible personal property who is liable as an endorser, guarantor, or indemnitor may deduct a reasonable addition to a reserve for bad debts from losses on the guaranteed debts.

This bill would eliminate the availability of the reserve method of deducting those debts for those dealers. It would also provide special transitional rules in connection with these changes.

(8) Under the existing Bank and Corporation Tax Law, gain from certain sales of property in exchange for which the seller receives deferred payments is reported on the installment method, unless the taxpayer elects otherwise.

This bill would limit the availability of the installment method of accounting in specified circumstances, including sales involving certain publicly traded property, sales pursuant to a revolving credit plan, and a portion of certain installment receivables, based on the amount of the outstanding indebtedness of the taxpayer. It would provide special transitional rules for some of these changes.

(9) This bill would become operative on January 1, 1988, and its tax provisions would be applicable in the computation of taxes for income years commencing on or after January 1, 1988.

The people of the State of California do enact as follows:

SECTION 1. Chapter 1.9 (commencing with Section 15365) is added to Part 6.7 of Division 3 of Title 2 of the Government Code, to read:

CHAPTER 1.9. CALIFORNIA EXPORT PROMOTION AND POLICY PROGRAM

Article 1. Trade Policy

15365. There is within the California State World Trade Commission a California Office of Trade Policy.

15365.2. The purposes of the California Office of Trade Policy are the following:

(a) To support vigorous enforcement of trade laws against unfair foreign trade practices in United States markets, in the markets of offending countries, and in third-country markets.

(b) To encourage international negotiations to reduce and eliminate restrictive trade practices abroad, including quotas,

tariffs, subsidies, nontariff barriers, and commercial counterfeiting.

(c) To participate in the development of international agreements which affect California's economic interests in cooperation with the Office of the United States Trade Representative.

(d) To respond to industry complaints concerning foreign trade barriers, and help represent their interests before appropriate agencies.

Article 2. Export Promotion

15365.6 There is within the California State World Trade Commission a California Office of Export Promotion.

15365.8 The purpose of the California Office of Export Promotion is to strengthen the state's activities in marketing its agricultural, manufacturing, and service industries overseas. The office shall be responsible for conducting market research; disseminating trade leads; sponsoring trade delegations, missions, marts, seminars, and other appropriate promotional events, and for establishing overseas offices in foreign countries, if appropriate and economically feasible. The office shall consult with the Department of Food and Agriculture on the promotion of agricultural commodities overseas.

SEC. 2. Chapter 6 (commencing with Section 15397) is added to Part 6.7 of Division 3 of Title 2 of the Government Code, to read:

CHAPTER 6. CALIFORNIA DEVELOPMENT REVIEW PANEL

Article 1. Membership

15397. (a) There is within the Business, Transportation and Housing Agency a Development Review Panel consisting of five members as follows:

(1) The Secretary of the Business, Transportation and Housing Agency, who shall serve as chairperson.

(2) The Secretary of the Resources Agency.

(3) The Secretary for Environmental Affairs.

(4) One Member of the Senate, appointed by the Senate Rules Committee.

(5) One Member of the Assembly, appointed by the Speaker of the Assembly.

(b) The Members of the Senate and Assembly shall meet with and, except as otherwise provided by the Constitution, advise the panel to the extent that this participation is not incompatible with their respective positions as Members of the Legislature.

(c) All necessary staffing to carry out the panel's duties and responsibilities shall be provided by the Department of Commerce.

Article 2. Purpose and Powers

15397.3 The purpose of the Development Review Panel shall be to promote and assist economic development projects in the state where additional development or expansion is otherwise not possible due to lack of adequate funding for infrastructure.

15397.5 It is the intent of the Legislature that funds appropriated for the purpose of the Development Review Panel not be used in lieu of or as supplemental funds to any existing state infrastructure financing program, including, but not limited to, the State Transportation Improvement Program or the Clean Water Bond Program.

15397.7. The panel shall meet regularly to review projects submitted to it for funding assistance. To facilitate its activities, the panel shall have the power to do all of the following:

(a) Adopt bylaws for the regulation of its affairs and the conduct of its business, and prepare and promulgate rules and regulations.

(b) Contract for legal, financial, and other services as well as services of appropriate state agencies as may, in its judgment, be necessary for it to evaluate an application for financial assistance.

(c) Make secured loans to any local agency in connection with the financing of public capital improvements projects in accordance with a loan agreement between the authority and the local agency.

(d) Assign or pledge all or any portion of its interests in mortgages, deeds of trust, indentures of mortgage or trust, or similar instruments, notes, and security interests in property, tangible or intangible, of a local agency to which the authority has made loans, and the revenues therefrom, including payment or income from any interest owed or held by the authority for the benefit of the holders of bonds issued to finance public capital improvements.

(e) Enter into any agreement or contract, execute any instrument, and perform any act or thing necessary, convenient, or desirable to carry out any power expressly given to the panel.

(f) Invest any moneys held in reserve or any moneys not required for immediate use or disbursement in obligations that are authorized by law for the investment of trust funds in the custody of the Treasurer.

(g) Request assistance and information from any department, division, board, commission, or other agency of the state as the panel may need to carry out its duties.

(h) Set such other terms and conditions by resolution pursuant to this section as it deems to be necessary, appropriate, and in the public interest in furtherance of the purposes of this chapter.

Article 3. Duties

15397.9 The panel shall establish criteria for the selection of projects to receive financing assistance. Criteria established by the panel shall include, but not be limited to, the following:

(a) The project must be demonstrated to be infeasible without the assistance of the panel.

(b) The project is needed to attract or otherwise accommodate the location or expansion of a specific industrial enterprise with high employment potential.

(c) A demonstration of community need for economic development.

(d) A demonstration of financial need for state assistance.

(e) Evidence of firm financial commitment on the part of the business or enterprise associated with the project.

(f) The cost per job created or retained is greater than or equal to a threshold established by the panel as part of its evaluation criteria.

(g) Evidence of site control, including any leases, easements, covenants, or encumbrances which may affect the project.

(h) Demonstration of ability to administer the project and state assistance requirements.

(i) Consistency with a city, county, or city and county general plan.

(j) Compliance with the California Environmental Quality Act as set forth in Division 13 (commencing with Section 21000) of the Public Resources Code.

15397.11. (a) Not less than 30 percent of the funds appropriated to the panel in any given fiscal year shall be set aside for projects submitted by rural cities and counties.

(b) For the purposes of this section, "rural city" means a city of less than 50,000 population located in a county of less than 600,000 population.

(c) For the purposes of this section, "rural county" means any unincorporated portion of a county of less than 200,000 population located within a county with a population of less than 600,000.

15397.13. Any city or county, or any city or county acting on behalf of a special district or local agency, may submit an application for financing assistance pursuant to this chapter which includes all of the following:

(a) A resolution in support of the public capital improvement and the financial assistance requested that has been adopted by the legislative body of the local agency.

(b) Financial, legal, and other information which is required by the panel to make a determination of significant public benefits.

(c) An estimate of the maximum amount and type of assistance to be requested.

(d) A description of the public capital improvement or project.

(e) A financing plan for the public capital improvement, including the amount of debt, if any, and the maximum term of maturity of any bond issue, and the identification of revenue sources that will be dedicated to the payment of the principal and interest on the bonds.

(f) A description of the public capital improvement's economic feasibility.

(g) The number of any type of permanent jobs to be either created or retained by the project.

15397.15. Applications for projects not in accordance with the reasonable priorities and criteria that the panel has established need not be accepted or further processed by the panel.

15397.17. The panel shall make a determination on the application within 30 days of receipt of the application, excepting that time required to correct deficiencies in the application.

15397.19. (a) The panel shall contract with local jurisdictions submitting projects accepted by the panel for financing assistance. For the purposes of this section, the panel shall be authorized to provide all of the following types of assistance:

(1) Interest rate assistance on local bonds.

(2) Grants-in-aid for projects.

(3) Secured loans.

(4) Matching funds to increase eligibility for other funds.

(b) Not more than 50 percent of the funds committed by the panel in any given fiscal year may be for direct grants.

(c) Not more than two million dollars ($2,000,000) may be spent on any one project.

(d) Grants will only be made when other funding options are financially infeasible.

(e) Contracts will be executed within one week of approval of projects. Funds will be transferred within 30 days of execution of the contract.

(f) A report certifying completion of the project will be required of the recipient as will a closeout report certifying number of permanent employment opportunities created by the project.

15397.21. Neither the completion of the project nor the operation of the facility will have the proximate effect of relocation of any substantial operations of the company from one area of the state to another or in the abandonment of any substantial operations of the company within other areas of the state, or, if the completion or operation will have either of the effects, then completion or operation is reasonably necessary to prevent the relocation of any substantial operations of the company from an area within the state to an area outside the state.

15397.23. All moneys loaned or otherwise made available by the panel and that are required to be repaid shall be deposited in the California Unitary Fund (Article 12 (commencing with Section 16429.30) of Chapter 2 of Part 2 of Division 4) and entirely made available for the expenditure for the purposes and uses of the panel, upon appropriation by the Legislature.

SEC. 3. Chapter 5 (commencing with Section 15398) is added to Part 6.7 of Division of Title 2 of the Government Code. to read:

Chapter 7. Small Business Bond Insurance Corporation

15398. There is in state government a nonprofit public benefit corporation which shall be known as the Small Business Bond Insurance Corporation.

15398.1. The primary goal of the corporation is to increase the availability of long-term financing to small businesses in California. The primary method for accomplishing this goal shall be

through the provision of insurance or guarantees of the payment of bonds issued by or for the benefit of small businesses which utilize bond financing as a source of long-term capital, including bonds issued pursuant to the California Industrial Development Financing Act (Title 10 (commencing with Section 91500)). Other methods of achieving the primary goal, including bond pooling, may be adopted by the corporation.

15398.2. The corporation shall be a nonprofit public benefit corporation and shall be subject to the Nonprofit Public Benefit Corporation Law (Part 2 (commencing with Section 5110) of Division 2 of Title 1 of the Corporations Code), except as specifically provided in this chapter.

15398.3. (a) The corporation shall be governed by a board of directors consisting of seven members as follows:

(1) The Secretary of the Business, Transportation and Housing Agency or his or her designee.

(2) The Treasurer or his or her designee.

(3) The Executive Director of the Office of Small Business or his or her designee.

(4) Two members to be appointed by the Governor as follows:

(A) One member with a minimum of three years' experience as an officer or employee of a financial institution.

(B) One member with a minimum of three years' experience as an owner or employee of a small business.

(5) One member to be appointed by the Senate Rules Committee.

(6) One member to be appointed by the Speaker of the Assembly.

(b) The terms of the Governor's initial appointees shall be two years. The terms of subsequent appointees by the Governor and all appointees by the Senate Rules Committee and the Speaker of the Assembly shall be three years. The terms shall expire on December 31. All appointees shall serve at the pleasure of the

appointing authority and vacancies shall be filled by the appointing authority.

(c) Initial appointments to the board shall be made within 90 days of the operative date of this chapter.

15398.4. The board shall do all of the following:

(a) Elect a chair and vice chair from among its members. The chair, if present, shall preside at meetings of the board; otherwise the vice chair shall preside.

(b) Adopt bylaws as required to govern the conduct and operation of the board.

(c) File articles of incorporation with the Secretary of State. The articles shall include a statement of purposes that conforms to the goals set forth in this chapter.

(d) Hold regularly scheduled meetings, at least quarterly, to carry out the objectives and responsibilities of the board.

(e) Hire an executive director to provide overall management for the corporation's programs.

(f) Establish the salaries of the executive director and other staff.

(g) Promulgate rules and regulations necessary to the operation of the corporation's programs in an effective and fiscally sound manner.

(h) Adopt criteria establishing eligibility requirements for its programs.

(i) Issue an annual report to the Governor and the Legislature covering the operations and impact of its programs and recommending ways in which the state can improve the financial health of small businesses.

(j) Appoint advisory groups, as it deems necessary, to carry out the powers and duties of the board.

(k) Design, establish, and implement bond insurance, coinsurance, and bond pooling programs necessary to carry out the goals of this chapter.

15398.5. The executive director shall do all of the following:

(a) Carry out management directives of the board.

(b) Manage and disburse funds and maintain records.

(c) Direct all staff and, hire and dismiss employees.

(d) Submit an annual budget, with the approval of the board, which shall be included in the Governor's proposed budget.

(e) Coordinate the activities and programs of the corporation with those of the Office of Small Business, the State Assistance Fund for Energy, the California Business and Industrial Corporation, the California Export Finance Office, and the California Industrial Development Financing Advisory Commission in order to minimize duplication of effort and improve the effectiveness of the corporation's programs.

15398.6. (a) There is in the State Treasury the California Small Business Bond Insurance Reserve Fund the purpose of which is to receive federal, state, and private moneys, any return on investments of those moneys by the Treasurer, premiums which may be charged by the corporation for insurance or coinsurance programs, and recoveries and collections on claims paid by the corporation. All moneys in the fund, upon appropriation by the Legislature, shall be allocated by the board for the corporation's small business bond insurance programs in accordance with the purposes of this chapter.

(b) Upon appropriation by the Legislature, all moneys in the fund shall be paid out by the Treasurer on warrants drawn by the Controller upon order of the board in furtherance of the purposes of this chapter, including the payment of claims under programs of the board, payments for insurance, coinsurance, and reinsurance, and payments required by state, federal, or private bond insurance programs conducted by the board.

(c) The state shall not be liable or obligated in any way beyond the state money which is allocated and deposited in the fund from state money which is appropriated for that purpose.

(d) The board may request the Treasurer to invest those moneys in the fund which are not immediately encumbered by

the corporation's administrative or program costs, in securities issued by the Treasury of the United States government or the government of the State of California. Returns from these investments shall be deposited in the fund and, upon appropriation by the Legislature, shall be used to support loan guarantees, bond insurance, and bond coinsurance as provided in this chapter.

15398.7. (a) There is in the State Treasury the California Small Business Bond Insurance Corporation Operations Fund the purpose of which is to receive state, federal, and private moneys to be used to cover the operating expenses of the corporation.

(b) Upon appropriation by the Legislature, all moneys in the fund shall be paid out by the Treasurer on warrants drawn by the Controller upon order of the board in furtherance of the purposes of this chapter.

(c) The corporation may charge fees for its guarantees, insurance, coinsurance, and other programs and these fees shall be deposited in the fund and, upon appropriation by the Legislature, shall be used to defray the operating expenses of the corporation.

15398.8. If the Legislature has appropriated funds to the California Small Business Bond Insurance Corporation Operations Fund, board members may receive reimbursement, including per diem equal to that received by state employees, for their actual and necessary expenses incurred in the performance of their duties. Board members, who are not employees of the state, may also be paid a stipend, at the discretion of the board, for each day they devote to official board business. The board shall determine the amount of the stipend; however, the stipend shall not exceed one hundred dollars ($100) for any calendar day. Board members may not receive stipends for more than 24 calendar days in any calendar year.

15398.9. (a) The Secretary of the Business, Transportation and Housing Agency or his or her designee shall act as the interim chair of the board of directors and shall continue in that capacity until a permanent chair is elected by the board. The interim chair shall, as soon after the operative date of this chapter as is practical, convene a meeting of the board.

(b) The board may request the Office of Small Business to provide staff support and other necessary assistance in establishing the corporation.

SEC. 4. Article 12 (commencing with Section 16429.30) is added to Chapter 2 of Part 2 of Division 4 of Title 2 of the Government Code, to read:

Article 12. California Unitary Fund

16429.30. There is in the State Treasury the California Unitary Fund, which is hereby created, consisting of all money deposited in the fund pursuant to any provision of law. There is also hereby created the Future Infrastructure State Targeted Account in the California Unitary Fund and the Local Project Account for Non-Transient Spending in the California Unitary Fund. All money in the fund shall be used exclusively for infrastructure financing and economic development.

16429.32. Eighty percent of the money deposited in the Future Infrastructure State Targeted Account shall be available for expenditure for the purposes and uses of the California Development Review Panel upon appropriation by the Legislature.

16429.34. Twenty percent of the money deposited in the Future Infrastructure State Targeted Account shall be available for expenditure only for the following purposes and uses upon appropriation by the Legislature:

(a) Support of the California Export Finance Program Law (Chapter 5 (commencing with Section 15390) of Part 6.7 of Division 3).

(b) Support of the California Export Promotion and Policy Program (Chapter 1.9 (commencing with Section 15365) of Part 6.7 of Division 3).

(c) Support of the California Small Business Bond Insurance Corporation (Chapter 7 (commencing with Section 15398) of Part 6.7 of Division 3).

(d) Support of the Foreign Market Development Export Incentive Program for California Agriculture Act, as established by Chapter 1189 of the Statutes of 1985.

16429.36. Any money deposited in the fund pursuant to Section 15397.23 shall not be subject to apportionment under Sections 16429.32 and 16429.34.

16429.38. All proposed appropriations from the fund shall be summarized in a section of the Governor's Budget for each fiscal year and shall bear the caption "California Unitary Infrastructure and Economic Development Program." The section shall contain a separate description of each program for which an appropriation is made. Appropriations shall be made to the department or entity administering the program and shall be accounted for separately.

16429.40. The Secretary of the Business, Transportation and Housing Agency shall be responsible for annually recommending to the Governor, for inclusion in the Budget Bill, which programs shall be supported by the California Unitary Fund.

16429.49. The moneys in the California Unitary Fund shall remain in the fund until appropriated by the Legislature and upon appropriation shall be used only for those purposes provided in this article.

SEC. 5. Section 24274 of the Revenue and Taxation Code is amended to read:

24274. There shall be included in gross income for the income year the amount of any increase in the suspense account required by subparagraph (B) of paragraph (2) of subdivision (c) of Section 24685 (relating to accrual of vacation pay).

SEC. 6. Section 24344 of the Revenue and Taxation Code is amended to read:

24344. (a) Except as limited by subdivision (b), there shall be allowed as a deduction all interest paid or accrued during the income year on indebtedness of the taxpayer.

(b) If income of the taxpayer which is derived from or attributable to sources within this state is determined pursuant to Section 25101 or 25110, the interest deductible shall be an amount equal to interest income subject to apportionment by formula, plus the amount, if any, by which the balance of interest expense exceeds interest and dividend income (except dividends

deductible under the provisions of Section 24402 and dividends subject to the deductions provided for in Section 24411 to the extent of those deductions) not subject to apportionment by formula. Interest expense not included in the preceding sentence shall be directly offset against interest and dividend income (except dividends deductible under the provisions of Section 24402 and dividends subject to the deductions provided for in Section 24411 to the extent of those deductions) not subject to apportionment by formula.

(c) Notwithstanding subdivision (b), interest expense incurred for purposes of foreign investments may be offset against dividends deductible under Section 24411.

SEC. 7. Section 24348 of the Revenue and Taxation Code is amended to read:

24348. (a) (1) There shall be allowed as a deduction either of the following:

(A) Debts which become worthless within the income year in an amount not in excess of the part charged off within that income year.

(B) In the case of a savings and loan association, bank, or financial corporation, in lieu of any deduction under subparagraph (A), in the discretion of the Franchise Tax Board, a reasonable addition to a reserve for bad debts.

(2) When satisfied that a debt is recoverable in part only the Franchise Tax Board may allow that debt, in an amount not in excess of the part charged off within the income year, as a deduction; provided, however, that if a portion of a debt is claimed and allowed as a deduction in any year no deduction shall be allowed in any subsequent year for any portion of the debt which in any prior year was charged off, regardless of whether claimed as a deduction in that prior year.

(b) (1) The amendments to this section made during 1985-86 Regular Session by the act adding this subdivision shall apply only to income years beginning after December 31, 1987.

(2) In the case of any taxpayer who maintained a reserve for bad debts for that taxpayer's last income year beginning before January 1, 1988, and who is required by the amendments to this section to change its method of accounting for any income year, all of the following shall apply:

(A) That change shall be treated as initated by the taxpayer.

(B) That change shall be treated as made with the consent of the Franchise Tax Board.

(C) The net amount of adjustments required by Article 6 (commencing with Section 24721) of Chapter 13, to be taken into account by the taxpayer shall:

(i) In the case of a taxpayer maintaining a reserve under former subdivision (b) (prior to the amendments made during the 1985-86 Regular Session by the act adding this subdivision), be reduced by the balance in the suspense account under paragraph (4) of that subdivision as of the close of such last income year; and

(ii) Be taken into account ratably in each of the first five income years beginning after December 31, 1987.

SEC. 8. Section 24411 is added to the Revenue and Taxation Code, to read:

24411. (a) For purposes of those taxpayers electing to compute income under Section 25110, 100 percent of the qualifying dividends described in subdivision (c) and 75 percent of the qualifying dividends described in subdivisions (b) and (d). "Qualifying dividends" means those received from corporations regardless of the place it is incorporated if both of the following conditions are satisfied:

(1) The average of the property, payroll, and sales factors within the United States for the corporation is less than 20 percent.

(2) More than 50 percent of the total combined voting power of all classes of stock entitled to vote is owned by the taxpayer.

(b) Qualifying dividends equal to the greatest amount of dividends received in any one of the income years constituting the base period.

(c) The amount of fully excluded dividends, if the taxpayer's greatest foreign payroll factor for any income year in the base period exceeds the taxpayer's foreign payroll factor for the income year, which shall be determined as follows:

(1) The taxpayer's foreign payroll factor in the income year shall be subtracted from the greatest of the taxpayer's foreign payroll factor for any income year in the base period.

(2) The amount determined pursuant to paragraph (1) shall be divided by the greatest of the taxpayer's foreign payroll factor for any income year in the base period.

(3) The percentage determined in paragraph (2) shall be multiplied by the total qualifying foreign dividends. The amount so determined shall be the amount of fully excluded dividends.

(4) The amount determined in paragraph (3) shall not exceed the amount of qualifying dividends in excess of the base dividends determined in subdivision (b).

(5) If the amount of fully excluded dividends determined pursuant to paragraph (3) is less than the amount of qualified dividends in excess of the amount of base dividends determined pursuant to subdivision (b), the difference shall be added to the base dividends determined pursuant to subdivision (b).

(d) The amount of partially excluded dividends, if the taxpayer's greatest foreign payroll factor for any income year in the base period is the same as or less than the taxpayer's foreign payroll factor in the income year, which shall be determined as follows:

(1) The taxpayer's greatest foreign payroll factor for any income year in the base period shall be subtracted from the taxpayer's foreign payroll factor in the income year.

(2) The amount determined pursuant to paragraph (1) shall be divided by the taxpayer's foreign payroll factor in the income year.

(3) The percentage determined in paragraph (2) shall be multiplied by the total qualifying foreign dividends.

(4) The amount determined in paragraph (3) shall be subtracted from the amount of qualifying dividends in excess of the amount of base dividends determined in subdivision (b).

(5) The balance shall be the amount of partially excluded dividends.

(e) The base period shall consist of the income year ending before January 1, 1987, and the two immediately preceding income years.

(f) A taxpayer's foreign payroll factor for an income year shall be a fraction, the numerator of which is the total amount paid outside the United States during the income year by the taxpayer and its affiliates for compensation, and the denominator of which is the total compensation paid everywhere during the income year.

SEC. 9. Section 24667 of the Revenue and Taxation Code is amended to read:

24667. (a) Except as otherwise provided in this section, income from an installment sale shall be taken into account for purposes of this part under the installment method.

(b) For purposes of this section —

(1) The term 'installment sale" means a disposition of property where at least one payment is to be received after the close of the income year in which the disposition occurs.

(2) The term 'installment sale" does not include —

(A) A disposition of personal property on the installment plan by a person who regularly sells or otherwise disposes of personal property on the installment plan.

(B) A disposition of personal property of a kind which is required to be included in the inventory of the taxpayer if on hand at the close of the income year.

(c) For purposes of this section, the term "installment method" means a method under which the income recognized for

any income year from a disposition is that proportion of the payments received in that year which the gross profit (realized or to be realized when payment is completed) bears to the total contract price.

(d) (1) Subdivision (a) shall not apply to any disposition if the taxpayer elects to have subdivision (a) not apply to such disposition.

(2) Except as otherwise provided, an election under paragraph (1) with respect to a disposition may be made only on or before the due date prescribed by law (including extensions) for filing the taxpayer's return of the tax imposed by this part for the income year in which the disposition occurs. Such an election shall be made in the manner prescribed by the Franchise Tax Board.

(3) An election under paragraph (1) with respect to any disposition may be revoked only with the consent of the Franchise Tax Board.

(e) (1) If—

(A) Any person disposes of property to a related person (hereinafter in this subdivision referred to as the "first disposition"), and

(B) Before the person making the first disposition receives all payments with respect to such disposition, the related person disposes of the property (hereinafter in this subdivision referred to as the "second disposition"),

then, for purposes of this section, the amount realized with respect to such second disposition shall be treated as received at the time of the second disposition by the person making the first disposition.

(2) (A) Except in the case of marketable securities, paragraph (1) shall apply only if the date of the second disposition is not more than two years after the date of the first disposition.

(B) The running of the two-year period set forth in subparagraph (A) shall be suspended with respect to any property for any

period during which the related person's risk of loss with respect to the property is substantially diminished by—

(i) The holding of a put with respect to such property (or similar property),

(ii) The holding by another person of a right to acquire the property, or

(iii) A short sale or any other transaction.

(3) The amount treated for any income year as received by the person making the first disposition by reason of paragraph (1) shall not exceed the excess of—

(A) The lesser of—

(i) The total amount realized with respect to any second disposition of the property occurring before the close of the income year, or

(ii) The total contract price for the first disposition, over

(B) The sum of—

(i) The aggregate amount of payments received with respect to the first disposition before the close of such year, plus

(ii) The aggregate amount treated as received with respect to the first disposition for prior income years by reason of this subdivision.

(4) For purposes of this subdivision, if the second disposition is not a sale or exchange, an amount equal to the fair market value of the property disposed of shall be substituted for the amount realized.

(5) If paragraph (1) applies for any income year, payments received in subsequent income years by the person making the first disposition shall not be treated as the receipt of payments with respect to the first dispoisiton to the extent that the aggregate of such payments does not exceed the amount treated as received by reason of paragraph (1).

(6) For purposes of this subdivision —

(A) Any sale or exchange of stock to the issuing corporation shall not be treated as a first disposition.

(B) A compulsory or involuntary conversion (within the meaning of Section 24944) and any transfer thereafter shall not be treated as a second disposition if the first disposition occurred before the threat or imminence of the conversion.

(C) Any transfer after the earlier of —

(i) The death of the person making the first disposition, or

(ii) The death of the person acquiring the property in the first disposition, and any transfer thereafter shall not be treated as a second disposition.

(7) This subdivision shall not apply to a second disposition (and any transfer thereafter) if it is established to the satisfaction of the Franchise Tax Board that neither the first disposition nor the second disposition had as one of its principal purposes the avoidance of bank and corporation tax.

(8) The period for assessing a deficiency with respect to a first disposition (to the extent such deficiency is attributable to the application of this subdivision) shall not expire before the day which is two years after the date on which the person making the first disposition furnishes (in such manner as the Franchise Tax Board may prescribe) a notice that there was a second disposition of the property to which this subdivision may have applied. Such deficiency may be assessed notwithstanding the provisions of any law or rule of law which would otherwise prevent such assessment.

(f) For purposes of this section —

(1) Except for purposes of subdivisions (g) and (h), the term "related person" means a person whose stock would be attributed under Section 24497 (other than subdivision (d) thereof) to the person first disposing of the property.

(2) The term "marketable securities" means any security for which, as of the date of the disposition, there was a market on an established securities market or otherwise.

(3) Except as provided in paragraph (4), the term "payment" does not include the receipt of evidences of indebtedness of the person acquiring the property (whether or not payment of such indebtedness is guaranteed by another person).

(4) Receipt of a bond or other evidence of indebtedness which —

(A) Is payable on demand, or

(B) Is issued by a corporation or a government or political subdivision thereof and is readily tradable, shall be treated as receipt of payment.

(5) For purposes of paragraph (4), the term "readily tradable" means a bond or other evidence of indebtedness which is issued —

(A) With interest coupons attached or in registered form (other than one in registered form which the taxpayer establishes will not be readily tradable in an established securities market), or

(B) In any other form designed to render such bond or other evidence of indebtedness readily tradable in an established securities market.

(6) In the case of any exchange described in subdivision (b) of Section 24941 —

(A) The total contract price shall be reduced to take into account the amount of any property permitted to be received in such exchange without recognition of gain,

(B) The gross profit from such exchange shall be reduced to take into account any amount not recognized by reason of subdivision (b) of Section 24941, and

(C) The term "payment," when used in any provision of this section other than paragraph (1) of subdivision (b), shall not include any property permitted to be received in such exchange without recognition of gain.

Similar rules shall apply in the case of an exchange which is described in Section 24535 and is not treated as a dividend.

(7) The term "depreciable property" means property of a character which (in the hands of the transferee) is subject to the allowance for depreciation provided in Section 24349.

(g) (1) In the case of an installment sale of depreciable property between related persons within the meaning of subdivision (b) of Section 1239 of the Internal Revenue Code, subdivision (a) shall not apply, and, for purposes of this part, all payments to be received shall be deemed received in the year of the disposition.

(2) Paragraph (1) shall not apply if it is established to the satisfaction of the Franchise Tax Board that the disposition did not have as one of its principal purposes the avoidance of bank and corporation tax.

(h) (1) (A) If, in connection with a liquidation to which Section 24512 applies, in a transaction to which Section 24501 applies the shareholder receives (in exchange for the shareholder's stock) an installment obligation acquired in respect of a sale or exchange by the corporation during the 12-month period set forth in subdivision (b) of Section 24512, then, for purposes of this section, the receipt of payments under such obligation (but not the receipt of such obligation) by the shareholder shall be treated as the receipt of payment for the stock.

(B) Subparagraph (A) shall not apply to an installment obligation described in paragraph (2) of subdivision (a) of Section 24513 unless such obligation is also described in paragraph (2) of subdivision (b) of Section 24513.

(C) If the obligor of any installment obligation and the shareholder are married to each other or are related persons (within the meaning of subdivision (b) of Section 1239 of the Internal Revenue Code), to the extent such installment obligation is attributable to the disposition by the corporation of depreciable property —

(i) Subparagraph (A) shall not apply to such obligation, and

(ii) For purposes of this part, all payments to be received by the shareholder shall be deemed received in the year the shareholder receives the obligation.

(D) For purposes of subparagraph (A) of paragraph (1) of subdivision (e), disposition of property by the corporation shall be treated also as disposition of such property by the shareholder.

(E) For purposes of subparagraph (A), in any case to which subdivision (c) of Section 24514 applies, an obligation acquired in respect of a sale or exchange by the selling corporation shall be treated as so acquired by the corporation distributing the obligation to the shareholder.

(2) If —

(A) Paragraph (1) applies with respect to any installment obligation received by a shareholder from a corporation, and

(B) By reason of the liquidation such shareholder receives property in more than one income year, then, on completion of the liquidation, basis previously allocated to property so received shall be reallocated for all such income years so that the shareholder's basis in the stock of the corporation is properly allocated among all property received by such shareholder in such liquidation.

(i) (1) In the case of any installment sale of property to which subdivision (a) applies, both of the following shall apply:

(A) Notwithstanding any other provision of this part, any recapture income shall be recognized in the year of the disposition.

(B) Any gain in excess of the recapture income shall be taken into account under the installment method.

(2) For purposes of paragraph (1), "recapture income" means, with respect to any installment sale, the amount by which the lower of —

(A) The recomputed basis of the property, or

(B) (i) In the case of a sale, exchange, or involuntary conversion, the amount realized, or

(ii) In the case of any other disposition, the fair market value of the property, exceeds the adjusted basis of the property.

(3) This subdivision shall not apply to any intallment sale of property which is irrigation equipment which is used to irrigate farmland.

(4) For purposes of this subdivision, "recomputed basis" means the adjusted basis of the property recomputed by adding thereto both of the following:

(A) All depreciation adjustments attributable to periods after December 31, 1962.

(B) Any amount deducted under Section 24356.3 (relating to expensing of certain business assets).

(j) (1) This section shall not apply to any installment obligation arising out of a sale of either of the following:

(A) Stock or securities which are traded on an established securities market.

(B) To the extent provided in regulations, property (other than stock or securities) of a kind regularly traded on an established market under regulations.

(2) This subdivision shall not apply to any sale of crops or livestock held for slaughter.

(3) The Franchise Tax Board may disallow the use of the installment method in whole or in part for transactions in which the rules of this subdivision otherwise would be avoided through the use of related parties or other intermediaries.

(k) (1) The Franchise Tax Board may prescribe such regulations as may be necessary or appropriate to carry out the provisions of this section.

(2) The regulations prescribed under paragraph (1) shall include regulations providing for ratable basis recovery in transactions where the gross profit or the total contract price (or both) cannot be readily ascertained.

(l) The amendments to this section made during the 1985-86 Regular Session by the act adding this subdivision shall apply only to dispositions made after December 31, 1987.

SEC. 10. Section 24668 of the Revenue and Taxation Code is amended to read:

24668. (a) (1) Under rules prescribed by the Franchise Tax Board, a person who regularly sells or otherwise disposes of personal property on the installment plan may return as income therefrom in any income year that proportion of the installment payments actually received in that year which the gross profit, realized or to be realized when payment is completed, bears to the total contract price.

(2) For purposes of paragraph (1), the total contract price of all sales of personal property on the installment plan includes the amount of carrying charges or interest which is determined with respect to such sales and is added on the books of account of the seller to the established cash selling price of such property.

(b) If the carrying charges or interest with respect to sales of personal property, the income from which is returned under paragraph (1) of subdivision (a), is not included in the total contract price, payments received with respect to such sales shall be treated as applying first against such carrying charges or interest.

(c) (1) This section shall not apply to any of the following:

(A) Any disposition of personal property under a revolving credit plan.

(B) Any installment obligation arising out of a sale of either of the following:

(i) Stock or securities which are traded on an established securities market.

(ii) To the extent provided in regulations, property (other than stock or securities) of a kind regularly traded on an established market under regulations.

(2) This subdivision shall not apply to any sale of crops or livestock held for slaughter.

(3) The Franchise Tax Board may disallow the use of the installment method in whole or in part for transactions in which the rules of this section otherwise would be avoided through the use of related parties or other intermediaries.

(d) (1) The amendments to this section made during the 1985-86 Regular Session by the act adding this subdivision shall apply only to dispositions made after December 31, 1987.

(2) In the case of any taxpayer who made sales under a revolving credit plan and was on the installment method under Section 24668 for that taxpayer's last income year beginning before January 1, 1988, and who is required by the amendments to this section made during the 1985-86 Regular Session by the act adding this subdivision to change its method of accounting all of the following apply:

(A) That change shall be treated as initiated by the taxpayer.

(B) That change shall be treated as having been made with the consent of the Franchise Tax Board.

(C) The period for taking into account adjustments under Article 6 (commencing with Section 24721) by reason of that change shall not exceed five years.

SEC. 11. Section 24670 is added to the Revenue and Taxation Code, to read:

24670. (a) For purposes of Section 24667 and 24668, if a taxpayer has allocable installment indebtedness for any income year, that indebtedness —

(1) Shall be allocated on a pro rata basis to any applicable installment obligation of the taxpayer which meets both of the following requirements:

(A) Arises in that income year.

(B) Is outstanding as of the close of that income year.

(2) Shall be treated as a payment received on that obligation as of the close of that income year.

(b) For purposes of this section:

(1) "Allocable installment indebtedness" means, with respect to any income year:

(A) The installment percentage of the taxpayer's average quarterly indebtedness for that income year, reduced (but not below zero) by —

(B) The aggregate amount treated as allocable installment indebtedness with respect to applicable installment obligations which —

(i) Are outstanding as of the close of that income year, but

(ii) Did not arise during that income year.

(2) "Installment percentage" means the percentage (not in excess of 100 percent) determined by dividing:

(A) The face amount of all applicable installment obligations of the taxpayer outstanding as of the close of the income year, by —

(B) The sum of both of the following:

(i) The aggregate adjusted basis of all assets not described in clause (ii) held as of the close of the income year.

(ii) The face amount of all installment obligations outstanding as of that time.

For purposes of clause (i) of subparagraph (B), a taxpayer may elect to compute the aggregate adjusted basis of all assets using the deduction for depreciation which is used in computing earnings and profits under Section 24491.1.

(3) For purposes of this subdivision:

(A) There shall not be taken into account under subparagraph (B) of paragraph (2) any property used in the trade or business of farming (within the meaning of Section 2032(A)(e)(4) or (5) of the Internal Revenue Code) or any installment obligation arising from the sale of that property.

(B) There shall not be taken into account in computing the taxpayer's average quarterly indebtedness under subparagraph

(A) of paragraph (1) any indebtedness secured by any property described in subparagraph (A).

(c) (1) If any amount is treated as received under subdivision (a) (after application of paragraph (2) of subdivision (d)) with respect to any applicable installment obligation, subsequent payments received on that obligation shall not be taken into account for purposes of Sections 24667 and 24668 to the extent that the aggregate of those subsequent payments does not exceed the aggregate amount treated as received under subdivision (a).

(2) For purposes of applying subparagraph (B) of paragraph (1) of subdivision (b) for the income year in which any payment to which paragraph (1) of this subdivision applies was received, and for any subsequent income year, the allocable installment indebtedness with respect to the applicable installment obligation shall be reduced (but not below zero) by the amount of that payment not taken into account by reason of paragraph (1).

(d) (1) The amount treated as received under subdivision (a) with respect to any applicable installment obligation for any income year shall not exceed the excess (if any) of:

(A) The total contract price, over

(B) Any portion of the total contract price received under the contract before the close of that income year:

(i) Including amounts so treated under subdivision (a) for all preceding income years, but

(ii) Not including amounts not taken into account by reason of subdivision (c).

(2) If after application of paragraph (1), the allocable installment indebtedness for any income year exceeds the amount which may be allocated to applicable installment obligations arising in, and outstanding as of the close of, that income year, that excess shall, subject to the limitations of paragraph (1), be allocated to applicable installment obligations outstanding as of the close of that income year which arose in preceding income years, beginning with applicable installment obligations arising in

the earliest preceding income year and shall be treated as a payment under paragraph (2) of subdivision (a).

(e) (1) "Applicable installment obligation" means any obligation which meets both of the following requirements:

(A) Arises from the disposition after December 31, 1987, of any of the following:

(i) Personal property under the installment method by a person who regularly sells or otherwise disposes of personal property on the installment plan.

(ii) Real property under the installment method which is held by the taxpayer for sale to customers in the ordinary course of the taxpayer's trade or business.

(iii) Real property under the installment method which is property used in the taxpayer's trade or business or property held for the production of rental income, but only if the sales price of that property exceeds one hundred fifty thousand dollars ($150,000). All sales and exchanges which are part of the same transaction (or a series of related transactions) shall be treated as one sale or exchange.

(B) Is held by the seller or a member of the same affiliated group as the seller.

(2) For purposes of this section, all members of-

(A) An affiliated group (within the meaning of Section 1504(a) of the Internal Revenue Code, but without regard to Section 1504(b) of the Internal Revenue Code), or

(B) A group under common control (within the meaning of Section 52(b) of the Internal Revenue Code), shall be treated as one taxpayer. The Franchise Tax Board may prescribe regulations for the treatment under this section of transctions between members of these groups.

(3) The Franchise Tax Board may provide that all (or any portion of) applicable installment obligations of a taxpayer may be treated as one obligation.

(4) (A) If a taxpayer elects the application of this paragraph, this section shall not apply to any installment obligation which meets both of the following requirements:

(i) Arises from a sale in the ordinary course of the taxpayer's trade or business to an individual of either of the following:

(I) A timeshare right to use or a timeshare ownership interest in residential real property for not more than six weeks, or a right to use specified campgrounds for recreational purposes.

(II) Any residential lot but only if the taxpayer (or any related person) is not to make any improvements with respect to that lot.

(ii) Is not guaranteed by any person other than an individual.

(B) If subparagraph (A) applies to any installment obligation, interest shall be paid on the portion of any tax for any income year (determined without regard to any deduction allowable for that interest) which is attributable to the receipt of payments on that obligation in that year (other than payments received in the income year of the sale). That interest shall be computed for the period from the date of the sale to the date on which the payment is received using the federal short-term rate under Section 1274 of the Internal Revenue Code (compounded semiannually) in effect at the time of the sale and adjusted annually to the federal short-term rate in effect on each anniversary of the sale.

(C) Any interest payable under this paragraph with respect to a payment shall be treated as an addition to tax for the income year in which the payment is received, except that the amount of that interest shall be taken into account in computing the amount of any deduction allowable to the taxpayer for interest paid or accrued during that income year.

(5) Except as otherwise provided, a shareholder who (after appication of Section 318 of the Internal Revenue Code) owns stock in a corporation meeting the requirements of Section 1504(a)(2) of the Internal Revenue Code shall be treated as a member of the affiliated group.

(6) The Franchise Tax Board may disallow the use of the installment method in whole or in part for transactions in which

the rules of this subdivision otherwise would be avoided through the use of related parties or other intermediaries.

(f) (1) Except as otherwise provided, this section shall apply to income years beginning after December 31,1987, with respect to dispositions after December 31, 1987.

(2) (A) This section shall not apply to any installment obligation arising from the disposition of tangible personal property by a manufacturer (or any taxpayer owned or controlled by the same interest, as defined by Section 25102) to a dealer if all of the following requirements are met:

(i) The dealer is obligated to pay on that obligation only when the dealer resells (or rents) the property.

(ii) The manufacturer has the right to repurchase the property at a fixed (or ascertainable) price after no later than the 9-month period beginning with the date of the sale.

(iii) The disposition is in an income year with respect to which the requirements of subparagraph (B) are met.

(B) The requirements of this subparagraph are met with respect to any income year if for that income year and the preceding income year the aggregate face amount of installment obligations described in subparagraph (A) is at least 50 percent of the total sales to dealers giving rise to those obligations, except that if the taxpayer met the requirements of this subparagraph for the preceding income year, then the taxpayer shall be treated as failing to meet the requirements of this subparagraph only in the second consecutive income year in which the 50-percent test is not met.

(C) An obligation issued before the date of the enactment of this section shall be treated as described in subparagraph (A) if, within 60 days after that date, the taxpayer modifies the terms of the obligation to conform to the requirements of subparagraph (A).

(D) In applying this section, any obligations described in subparagraph (A) shall not be treated as applicable installment

obligations (within the meaning of subparagraph (A) of paragraph (1) of subdivision (e)).

(E) This paragraph shall apply only if the taxpayer meets the requirements of subparagraphs (A) and (B) for its first income year beginning after the date of enactment of this section.

(3) In applying this section to any installment obligation of a corporation incorporated on January 13, 1928, the following indebtedness shall not be taken into account in determining the allocable installment indebtedness of that corporation under this section:

(A) Twelve and five-eighths percent subordinated debentures, with a total face amount of one hundred seventy-five million dollars ($175,000,000) issued pursuant to a trust indenture dated as of September 1, 1985.

(B) A revolving credit term loan in the maximum amount of one hundred thirty million dollars ($130,000,000) made pursuant to a revolving credit and security agreement dated as of September 6, 1985, payable in various stages with final payment due on August 31, 1992.

This paragrpah shall also apply to indebtedness which replaces indebtedness described in this paragraph if that indebtedness does not exceed the amount and maturity of the indebtedness it replaces.

SEC. 12. Section 25110 of the Revenue and Taxation Code is amended and renumbered to read:

25108. (a) For corporations whose income is subject to the provisions of Section 25101 or 25101.15, the net operating loss determined in accordance with Section 172 of the Internal Revenue Code, as modified by Section 24416, for a particular income year (taxable year of corporations subject to the tax imposed by Chapter 3) shall be the corporation's "net loss for state purposes" as defined in subdivision (c).

(b) The net operating loss deduction allowed by Section 24416 for an income year (taxable year of corporations subject to the tax imposed by Chapter 3) shall be deducted from "net income for

state purposes" (as defined in subdivision (c)) for that income year (taxable year of corporations subject to the tax imposed by Chapter 3.

(c) "Net income (loss) for state purposes" means the sum of the net income or loss of that corporation apportionable to this state and the income or loss allocable to this state as nonbusiness income, as provided by Chapter 17 (commencing with Section 25101).

SEC. 6. Article 1.5 (commencing with Section 25110) is added to Chapter 17 of Part 11 of Division 2 of the Revenue and Taxation Code, to read:

Article 1.5. Water's-Edge Election

25110. (a) Notwithstanding Section 25101, a qualified taxpayer, as defined in paragraph (2) of subdivision (b) which is subject to the tax imposed under this part, may elect to determine its income derived from or attributable to sources within this state pursuant to a water's-edge election in accordance with the provisions of this part, as modified by this article. A taxpayer which makes a water's-edge election shall take into account the income and apportionment factors of the following affiliated entities only:

(1) Affiliated banks or corporations which are eligible to be included in a federal consolidated return as described in Sections 1501 to 1505, inclusive, of the Internal Revenue Code.

(2) Domestic international sales corporations, as described in Sections 991 through 994 of the Internal Revenue Code and foreign sales corporations as described in Sections 921 through 927 of the Internal Revenue Code.

(3) Any corporation, regardless of the place where it is incorporated if the average of its property, payroll, and sales factors within the United States is 20 percent or more.

(4) Banks and corporations which are incorporated in the United States, excluding corporations described in Sections 931 to 936, inclusive, of the Internal Revenue Code, of which more

than 50 percent of their stock is controlled directly or indirectly by the same interests, which are not included in paragraph (1).

(5) A bank or corporation which is not described in paragraphs (1) to (4), inclusive, or paragraph (6), but only to the extent of its income derived from or attributable to sources within the United States and its factors assignable to a location within the United States in accordance with paragraph (3). Income of such a bank or corporation derived from or attributable to sources within the United States shall be limited to and determined from the books of account maintained by the bank or corporation with respect to its activities conducted within the United States as determined by federal income tax law.

(6) Export trade corporations, as described in Sections 970 to 972, inclusive, of the Internal Revenue Code.

(7) (A) (A) The income and factors of the above-enumerated banks and corporations shall be taken into account only if the income and factors would have been taken into account under Section 25101 if this section had not been enacted.

(B) The income and factors of a bank which is not described in paragraphs (1) to (4), inclusive, and (6) and which is an electing taxpayer under this subdivision shall be taken into account in determining its income only to the extent set forth in paragraph (5).

(8) Any affiliated bank or corporation which is a "controlled foreign corporation", as defined in Section 957 of the Internal Revenue Code, if all or part of the income of that affiliate is defined in Section 952 of Subpart F of the Internal Revenue Code ("Subpart F income"). The income and apportionment factors of any affiliate to be included under this paragraph shall be determined by multiplying the income and apportionment factors of that affiliate without application of this paragraph by a fraction (not to exceed one), the numerator of which is the "Subpart F income" of that bank or corporation and the denominator of which is the "earnings and profits" of that bank or corporation, as defined in Section 964 of the Internal Revenue Code.

(b) For purposes of this section:

(1) An "affiliated bank or corporation," for purposes of this article, means a bank or corporation which is part of one or more chains of banks or corporations connected through stock ownership with a common parent if both of the following exist:

(A) Over 50 percent of the voting stock of the bank or corporation is directly or indirectly owned or controlled by one or more of the other banks or corporations.

(B) The common parent owns directly or indirectly over 50 percent of the voting stock of at least one of the other banks or corporations.

(2) A "qualified taxpayer" means a bank or corporation which does both of the following:

(A) Files with the state tax return on which the water's-edge election is made a consent to the taking of depositions from key domestic corporate individuals and to the acceptance of subpoenas duces tecum requiring reasonable production of documents to the Franchise Tax Board as provided in Section 26423 or by the State Board of Equalization or by the courts of this state. The consent shall remain in effect so long as the water's-edge election is in effect and shall be limited to providing that information necessary to review or to adjust income or deductions in a manner authorized under Sections 482, 861, Subpart F of Part III of Subchapter N, or similar provisions of the Internal Revenue Code, together with the regulations adopted pursuant thereto, and for the conduct of an investigation with respect to any unitary business in which the taxpayer may be involved.

(B) Agrees that for purposes of this article, dividends received by any bank or corporation whose income and apportionment factors are taken into account pursuant to subdivision (a) from either of the following shall be deemed to be functionally related dividends subject to Section 24111 and shall be presumed to be business income:

(i) A bank or corporation of which more than 50 percent of the voting stock is owned, directly or indirectly, by members of

the unitary group and which is engaged in the same general line of business.

(ii) Any bank or corporation which is either a significant source of supply for the unitary business or a significant purchaser of the output of the unitary business, or which sells a significant part of its output or obtains a significant part of its raw materials or input from the unitary business. "Significant," as used in this subparagraph, means an amount of 15 percent or more of either input or output.

All other dividends shall be classified as business or nonbusiness income without regard to this subparagraph.

(3) The definitions and locations of property, payroll, and sales shall be determined under the laws and regulations which set forth the apportionment formulas used by the individual states to assign net income subject to taxes on or measured by net income in that state. If a state does not impose a tax on or measured by net income or does not have laws or regulations with respect to the assignment of property, payroll, and sales, the laws and regulations provided in Article 2 (commencing with Section 25120) shall apply.

Sales shall be considered to be made to a state only if the bank or corporation making the sale may otherwise be subject to a tax on or measured by net income under the Constitution or laws of the United States, and shall not include sales made to a bank or corporation whose income and apportionment factors are taken into account pursuant to their subdivision.

(4) The Franchise Tax Board, for purposes of administering the provisions of Sections 25110 and 15115, shall examine the returns filed by taxpayers subject to these provisions. Where this examination reveals potential noncompliance, a detailed examination shall be made notwithstanding the potential net revenue benefit to the state unless the taxpayer is being examined by the Internal Revenue Service for the same year or years on the same issues.

In any case of two or more organizations, trades, or businesses (whether or not organized in the United States and whether or

not affiliated) owned or controlled directly or indirectly by the same interests, the Franchise Tax Board may distribute, apportion, or allocate gross income, deductions, credits, or allowances between or among these organizations, trades, or business, if the board determines that the distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any of these organizations, trades, or businesses.

In making distributions, apportionments, and allocations under this section, the Franchise Tax Board shall generally follow the rules, regulations, and procedures of the Internal Revenue Service in making audits under Section 482 of the Internal Revenue Code. Any of these rules, regulations, and procedures adopted by the Franchise Tax Board shall not be subject to review by the Office of Administrative Law.

If the Internal Revenue Service has conducted a detailed audit under Section 482 of the Internal Revenue Code and has made adjustments pursuant to that section, it shall be presumed that no further adjustments are necessary for this state's purposes. If the Internal Revenue Service has conducted a detailed audit under this section and has made or proposed no adjustments to the transaction examined, it shall be presumed that no adjustment is necessary for this state's purposes. These presumptions shall be overcome if the Franchise Tax Board or the taxpayer demonstrates that an adjustment or a failure to make an adjustment was erroneous, if it demonstrates that the results of such an adjustment would produce a minimal tax change for federal purposes because of correlative or offsetting adjustments or for other reasons, or if substantially the same federal tax result was obtained under other sections of the Internal Revenue Code. No inference shall be drawn from an Internal Revenue Service failure to audit international transactions under Section 482 of Internal Revenue Code and it shall not be presumed that any such transactions were correctly reported.

(5) "The United States" means the 50 states of the United States and the District of Columbia.

(c) All references in this part to income determined pursuant to Section 25101 shall also mean income determined pursuant to this section.

(d) A water's-edge election may be disregarded by the Franchise Tax Board only if any of the following occurs:

(1) A bank or corporation fails to comply substantially with Section 25114 or any federal law requiring the filing of domestic spreadsheets.

(2) After a reasonable adjustment of transfer prices, royalty rates, the allocation of common expenses, and similar adjustments, the return filed pursuant to this section fails to prevent the evasion of taxes.

(3) An otherwise qualified taxpayer fails to do any of the following:

(A) Retain and make available upon request the documents and information, including any questionnaires completed and submitted to the Internal Revenue Service or qualified states, which are necessary to audit issues involving attribution of income to the United States or foreign jurisdictions under Sections 482, 861, 863, 902, 904, and Subpart F of Part III of Subchapter N, or similar sections of the Internal Revenue Code.

(b) Identify, upon request, principal officers or employees who have substantial knowledge of and access to documents and records which discuss pricing policies, profit centers, cost centers, and the methods of allocating income and expense among these centers. The information shall include the employees' titles and addresses.

(C) Retain and make available upon request all documents and correspondence ordinarily available to a bank or corporation included in the water's-edge election which are submitted to or obtained from the Internal Revenue Service, foreign countries or their territories or possessions, and competent authority pertaining to ruling requests, rulings, settlement resolutions, and competing claims involving jurisdictional assignment and sourcing of income that affect the assignment of income to the United States. The documents shall include all ruling requests and rulings on reorga-

nizations involving foreign incorporation of branches, all ruling requests and rulings on changing a bank or corporation's jurisdictional incorporation, and all documents which are ordinarily available to a bank or corporation included in the water's-edge election which pertain to the determination of foreign tax liability, including examination reports issued by foreign taxing administrations. If the documents have been translated, the translations shall be furnished.

(D) Prepare and make available upon request for each bank or corporation included in the disclosure spreadsheet referred to in subdivision (a) of Section 25114 in which the taxpayer is included, a list of each state of the United States, including the District of Columbia, territories or possessions, and each foreign country in which it has payroll, property, or sales. The sales shall be determined by destination whether or not the taxpayer is taxable in the destination jurisdiction.

(E) Retain and make available upon request forms filed with the Internal Revenue Service to comply with Sections 6038, 6038A, and 6041 of the Internal Revenue Code.

(F) Prepare and make available upon request, for each bank or corporation organized or created under the laws of the United States or a political subdivision thereof, of which 50 percent or more of its voting stock is directly or indirectly owned or controlled, the information which would be included in the forms described in subparagraph (E) if those forms were required for United States corporations.

(G) Retain and make available upon request all state tax returns filed by each bank or corporation included under subdivision (a) in each state, including the District of Columbia.

(H) Comply with reasonable requests for discovery directed at obtaining information necessary to determine or verify its net income, apportionment factors, or the geographic source of that income pursuant to the Internal Revenue Code.

(I) For purposes of this subdivision, information for any year shall be retained for that period of time in which the taxpayer's income or franchise tax liability to this state may be subject to

adjustment, including all periods in which additional income or franchise taxes may be assessed or during which an appeal is pending before the State Board of Equalization or a lawsuit is pending in the courts of this state or the United States with respect to California franchise or income tax.

(4) A failure to satisfy any of the requirements of paragraph (3) shall mean a willful failure to retain and make available documents that are material to a determination by the Franchise Tax Board of a qualified taxpayer's tax under this part.

25111. (a) A water's-edge election shall be made by contract with the Franchise Tax Board in the original return for a year and shall be effective only if every affiliated bank or corporation subject to tax under this part consents to the election. Consent by the common parent of an affiliated group shall constitute consent of all members of the group. The form and manner of making the water's-edge election shall be prescribed by the Franchise Tax Board. Each contract making a water's-edge election shall be for an initial term of 10 years, except as provided in subdivision (b). Each contract shall provide that on the anniversary date of the contract or any other annual date specified by the contract a year shall be added automatically to the initial term unless notice of nonrenewal is given as provided in subdivision (d). Each contract shall be conditioned by an agreement to pay the amount specified in Section 25115. Except as provided in subdivision (b), the Franchise Tax Board shall enter into a contract as provided by this section with any qualified taxpayer which wishes to make a water's-edge election. An affiliated bank or corporation which becomes subject to tax under this part subsequent to the water's-edge election shall be deemed to have consented to the election. No water's-edge election shall be made for an income year beginning prior to the operative date of this article.

(b) A water's-edge election may be disregarded by the Franchise Tax Board as provided in subdivision (d) of Section 25110 and may be changed by a taxpayer prior to the end of the 10-year period only with the permission of the Franchise Tax Board.

(c) In disregarding an election or in granting a change of election, the Franchise Tax Board shall impose any conditions which are necessary to prevent the avoidance of tax or clearly reflect income for the period the election was, or was purported to be, in effect. These conditions may include a requirement that income, including dividends paid from income earned while a water's-edge election was in effect, which would have been included in determining the income of the taxpayer from sources within and without this state pursuant to Section 25101 but for the water's-edge election shall be included in income in the year in which the election is changed or disregarded.

(d) If the taxpayer desires in any year not to renew the contract, the taxpayer shall serve written notice of nonrenewal of the contract upon the board in advance of the annual renewal date of the contract. Unless that written notice is served by the taxpayer at least 90 days prior to the renewal date, the contract shall be considered renewed as provided in subdivision (a).

If the taxpayer serves notice of intent in any year not to renew the contract, the existing contract shall remain in effect for the balance of the period remaining since the original execution or the last renewal of the contract, as the case may be.

25112. (a) If a taxpayer electing under Section 25110 fails to supply any required information, in addition to being subject to disqualification by the Franchise Tax Board pursuant to Section 25110 and to any penalties otherwise provided by this part, the taxpayer shall pay a penalty of one thousand dollars ($1,000) for each income year with respect to which the failure occurs.

(b) If the failure continues for more than 90 days after the date on which the Franchise Tax Board mails notice of that failure to the taxpayer, the taxpayer shall pay a penalty (in addition to the amount required under subdivision (a)) of one thousand dollars ($1,000) for each 30-day period (or fraction thereof) during which the failure continues after the expiration of the 90-day period. The increase in any penalty under this subdivision shall not exceed twenty-four thousand dollars ($24,000).

(c) If the taxpayer fails to comply substantially with any formal document request arising out of the examination of the tax

treatment of any item (hereinafter in this section referred to as the "examined item") before the 90th day after the date of the mailing of the request, any court having jurisdiction of a civil proceeding in which the tax treatment of the examined item is an issue shall, upon motion by the Franchise Tax Board, prohibit the introduction by the taxpayer of any documentation covered by that request.

(d) For purposes of this section, the time in which information is to be furnished (and the beginning of the 90-day period after notice by the Franchise Tax Board) shall be treated as beginning not earlier than the last day on which reasonable cause existed for failure to furnish the information.

(e) This section shall not apply with respect to any requested documentation if the taxpayer establishes that the failure to provide the documentation, as requested by the Franchise Tax Board, is due to reasonable cause. For purposes of subdivision (c), the fact that a foreign jurisdiction would impose a civil or criminal penalty on the taxpayer (or any other person) for disclosing the requested documentation is not reasonable cause.

(f) For purposes of this section, the term "formal document request" means any request (made after the normal request procedures have failed to produce the requested documentation) for the production of documentation which is mailed by registered or certified mail to the taxpayer at its last known address and which sets forth all of the following:

(1) The time and place for the production of the documentation.

(2) A statement of the reason the documentation previously produced (if any) is not sufficient.

(3) A description of the documentation being sought.

(4) The consequences to the taxpayer of the failure to produce the documentation described in this section.

(g) Notwithstanding any other law or rule of law, any taxpayer to whom a formal document request is mailed may begin a proceeding to quash that request not later than the 90th day after

the date the request was mailed. In any such proceeding, the Franchise Tax Board may seek to compel compliance with the request.

(h) The superior courts of the State of California for the Counties of Los Angeles, Sacramento, and San Diego, and for the City and County of San Francisco shall have jurisdiction to hear any proceeding brought under subdivision (g). An order denying the petition shall be deemed a final order which may be appealed.

The running of the 90-day period referred to in subdivision (b) shall be suspended during any period during which a proceeding brought under subdivision (g) is pending.

(i) For purposes of this section, "documentation" means any documentation which may be relevant or material to the tax treatment of the examined item.

(j) The Franchise Tax Board, and any court having jurisdiction over a proceeding under subdivision (g), may extend the 90-day period referred to in subdivision (b).

(k) If any bank or corporation takes any action as provided in subdivision (g), the running of any period of limitations under Sections 25663 to 25663d, inclusive (relating to the assessment and collection of tax), or under Section 25964 (relating to criminal prosecutions) with respect to that bank or corporation shall be suspended for the period during which the proceedings under subdivision (g) and appeals thereto are pending.

25113. (a) In any administrative or judicial proceeding, the Franchise Tax Board may introduce into evidence the record of any final court determination in another state involving the same taxpayer or a unitary business of which the taxpayer is alleged to be a member.

(b) Tax information pertaining to the examination of multinational operations, including underlying data, obtained from the Internal Revenue Service or a foreign government shall be admissible into evidence in an administrative or judicial proceeding involving a taxpayer's liability under this part without being contestable as to its relevancy.

25114. Any bank or corporation required to file a United States tax return or which could be included in a consolidated federal tax return shall file with the Franchise Tax Board within three months after the bank or corporation files its federal income tax return a domestic disclosure spreadsheet if it and its related corporation's payroll, property, or sales in a foreign country exceeds one million dollars ($1,000,000) or if it and its related corporation's total assets exceed two hundred fifty million dollars ($250,000,000), or such higher levels as may be subsequently established by regulation. For purposes of this paragraph, two corporations are related if more than 50 percent of the voting stock of one company is directly or indirectly owned or controlled by the other or if more than 50 percent of the voting stock of both is directly or indirectly owned or controlled by the same interest. The spreadsheet shall provide for full disclosure as to the income reported to each state, the state tax liability, and the method used for apportioning or allocating income to the states, and any other information as provided for by regulations as may be necessary to determine properly the amount of taxes due to each state and to identify the corporate parent and those of its affiliates of which more than 20 percent of the voting stock is directly or indirectly owned or controlled by the parent. The spreadsheet shall be reviewed for completeness by the Franchise Tax Board and if it is not properly completed shall not be accepted and shall be subject to penalties.

25115. (a) Each contract described in Section 25111 shall provide that a taxpayer making a water's-edge election pursuant to this article shall pay an annual amount to the Franchise Tax Board for deposit in the California Unitary Fund created pursuant to Section 16429.30 of the Government Code. One-third of the amount shall be deposited in the Local Project Account for Non-Transient Spending in the California Unitary Fund, and two-thirds of the amount shall be deposited in the Future Infrastructure State Targeted Account in the California Unitary Fund.

(b) The amount shall be equal to thirty-thousandths of 1 percent of the sum of the taxpayer's property, payroll, and sales in

this state, as defined in this chapter, with the following adjustments:

(1) Intangibles shall not be included in the property factor.

(2) The property and payroll factors shall be with respect to the income year ending during calendar year 1986.

(3) The sum of the property, payroll, and sales shall be reduced by the cumulative amount expended since January 1, 1988, for investment in new plants or facilities in this state, as defined in subdivision (c), and shall further be reduced by the amount expended for new employees in this state as defined in subdivision (e).

(c) A new plant or facility is property described in Section 70, provided that it is not a replacement, in whole or in part, for an existing plant or facility in this state. A plant or facility shall be deemed a replacement if the taxpayer, or an affiliated bank or corporation, as defined in paragraph (1) of subdivision (b) of Section 25110, closes, takes out of service, sells, or leases to an unrelated party, in either the three immediately preceding or the three immediately succeeding years from the time the new plant or facility is operational, a plant or facility with a cost basis equal to 25 percent or more of the cost basis of the new plant or facility.

(d) The number of new employees in this state for any income year shall be determined by comparing the total number of work years in this state for the income year to the greater of (1) the average of the total number of work years in this state for the income years ending in 1985, 1986, and 1987, or (2) the total number of work years in this state for the income year ending in 1987. A "work year" means, in the case of workers who are paid an hourly wage, 2,000 paid hours, and in the case of salaried employees, a total of 12 paid months.

(e) The amount expended for new employees shall be equal to the product of the number of new employees determined pursuant to subdivision (d) and the average wages paid for each work year in this state for the income year.

(f) Each contract shall provide that the amount described in this section shall not be subject to any statutory changes, for the

period the contract is in effect, without the consent of the taxpayer. Any statutory change shall be applicable for any renewal year beginning 10 years after that statutory change.

(g) Amounts determined pursuant to this section shall be collected in the same manner as the taxes imposed by this part and shall be subject to interest and penalties as provided in this part.

(h) In no event shall the amount determined pursuant to this section be less than ten-thousandths of the sum of the taxpayer's property, payroll, and sales in this state for the current year.

(i) The annual amount otherwise determined pursuant to this section and payable under a contract described in Section 25111 shall not be imposed for an income year in which a taxpayer incurs no tax liability under Sections 25101 and 25110.

SEC. 14. The Franchise Tax Board shall study its current auditing practices and those of the Internal Revenue Service for so-called 80-20 corporations, and the equity of the treatment of those corporations pursuant to this act. The Franchise Tax Board shall present a report to the Legislature no later than March 1, 1987, which identifies additional authority needed, if any, to adequately audit so-called 80-20 corporations if those corporations were outside the water's edge and which sets forth its findings with respect to the equity treatment.

SEC. 15. This act shall become operative on January 1, 1988. The provisions of this act shall be applicable in the computation of taxes for income years commencing on or after January 1, 1988.

EXHIBIT 56

H. M. TREASURY
Parliament Street, London SW1P 3AG
Press Office: 01-233 3415
Telex: 262405

5 September 1986

UNITARY TAX

The Government welcome the passage of legislation in California limiting the use of worldwide unitary taxation.

This is a major step towards the complete withdrawal of this method of taxation, which both the Government and representatives of British industry have been seeking for some time. In the last two years there has been action to reform unitary tax in a number of states. But the California legislation is particularly significant in view of the size of the State's economy and its importance to the UK as a location for investment.

The government have reservations about some aspects of the California Legislation, and will continue to look for a comprehensive solution to this problem as outlined by the President in his Statement last November. They acknowledge the important contributions of the federal government in working towards unitary tax reform and will seek its continued support in the unitary tax court cases. The Government are also discussing with the US authorities the future of the Unitary Tax Bill now before Congress and the prospects for amendment to the UK/US Double Taxation Convention.

PRESS OFFICE
H M TREASURY
PARLIAMENT STREET
LONDON SW1P 3AG

113/86

Notes for Editors

The internationally accepted principle is that tax authorities charge tax on foreign-owned companies only on the profits arising in the country or state for which they are responsible. However, a number of US states tax foreign-owned companies on a conventional share of the worldwide income of the Group. This means, for example, that a UK group operating in California may have to pay tax on income arising outside the state, giving rise to double taxation. It may also face heavy compliance costs in furnishing details of its worldwide operations.

2. The UK Government has consistently opposed the application of unitary taxation to international business. So has the CBI. So have many other countries. It is contrary to internationally accepted principles and results in unreasonable tax and compliance burdens.

3. In 1979 the US Senate rejected the provision (Article 9(4)) included in the US/UK double taxation agreement, as signed, which would have prevented US states from applying the unitary method to UK companies with US subsidiaries.

4. In July 1984, a Working Group under the Chairmanship of (then) US Treasury Secretary Regan, agreed on the principle that unitary taxation should be limited to the United States water's edge, but failed to resolve a number of issues. Secretary Regan said in his Chairman's Report, (July 1984), that if there were not "sufficient signs of appreciable progress" at states level by 31 July 1985, he would recommend to the President that the Administration should propose federal legislation.

5. Since July 1984, there has been action to reform unitary tax in a number of states — Oregon, Florida, Massachusetts, Indiana, Utah, Colorado, New Hampshire, Idaho and now California — though in some cases the application of unitary tax to foreign-owned corporations is limited and not eliminated. Legislative initiatives have not succeeded in the remaining three states which apply unitary tax to foreign-owned business (Alaska, North Dakota and Montana).

6. In July 1985, Parliament passed a provision (Section 54, Finance Act 1985), under which the UK could withdraw from US parent companies situated in unitary states, the entitlement to tax credits relating to dividends paid by UK subsidiaries. This provision would take effect by statutory instrument, subject to affirmative resolution of the House of Commons.

7. Last November, HM Government and the US President, issued statements on plans to resolve the unitary tax issue. These were followed in December by the publication of draft federal legislation in the US. Hearings are scheduled on this draft legislation later this month.

8. It is understood that the Californian legislation would allow companies to elect not to have their California tax assessment made on the worldwide unitary basis. However, companies so electing would have to pay an election fee. In addition, the Californian tax authorities would still retain powers to impose the use of worldwide unitary taxation in certain circumstances.

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EXHIBIT 72K

10 DOWNING STREET

THE PRIME MINISTER 8 November 1983

Dear Michael

Thank you for your letter of 6 October. You will since have received mine of 7 October, in which I told you of my discussion with President Reagan and Treasury Secretary Regan about Unitary Taxation. I am grateful for what you say about the way I dealt with this issue in Washington.

It was of course a disappointment that the President has decided not to take action to sponsor or support legislation prohibiting Unitary Taxation but instead to place the matter in the hands of a Working Group. But you may be pessimistic in assuming that this will freeze any further activity indefinitely: we have been assured that the Working Group are under instructions not to delay their deliberations. You may like to know that HMG has now been invited to make representations to the Commission.

We shall of course also continue to remind the Administration of our very strong concern over the matter. I have no doubt that British businesses will continue to do so as well. This can only be helpful.

Nigel Lawson also raised the question with our Community partners when he was in Luxembourg last week. He received general support from his colleagues, and as a result further consideration is being given to ways to concert Community action in Washington.

Margaret Thatcher

Michael Grylls, Esq., M.P.

EXHIBIT 75

Summary of Cost Compliance

Bernard L. Caldwell

18 Calif. Admin. Code 25737-6

Barclays Bank

		000's
Set-Up Costs		\$3,400(1)
Systems Costs		3,000(2)
Annual Compliance Cost	\$1,700(3)	
Annual Maintenance and Training Cost	300(4)	
Total Annual Cost		\$2,000
Total Compliance Cost		\$8,400

(1) Estimate based upon a factor of 2 times the annual compliance costs.

(2) Based on 1979 mechanization work for a large multinational corporation, considering a 25% increase in costs over the 7 years.

(3) Based on cost comparison of the estimated state compliance costs of a large multinational financial corporation plus an additional amount to take into account the effort required by BBPLC due to no synergism associated with a U.S. filing requirement by the comparable bank. Estimated additional costs 35-50%.

(4) Estimated to run at 20% of annual compliance.

EXHIBIT RR

RETURN ROUTING AND CONTROL FORM

Taxpayer's Name Barclays Bank International, Ltd.

Code Number 06915-015

☐ Computer Process
☒ Manual

☒ Corporate (Bank)
☐ Partnership
☐ Fiduciary
☐ Individual
☐ Exempt Organization
(Other) ______________

* SHOW ALL TIME CHARGED

	1972		
	Last Name	Date Completed	*Time
Interviewed Client			
Prepared	Haney	6/1/73	13*+1
Reviewed..................	[illegible]	6/12/73	4
Computax Reviewed (If Applicable)...........	—		—
Typed			
Proofread..................			
Processed	Honi	6/13/73	1
Assembly Checked by Reviewer	[illegible]	6/13/73	—
Manager Review & Approval for Signature ...	Vickrey	6/13/73	2
Signed & Dated	[illegible]	6/13/73	

Safe Declarations Yes ☐ No ☐

Special Instructions/Explain high or low time charges below.

* Data submitted less complete than [illegible], correction made by client causing correction in PW work.

Price Waterhouse

197_			9/30 1974		
Last Name	Date Completed	*Time	Last Name	Date Completed	*Time
Anderson	6/3/74	10	Koch	6/4/75	10+1
Rickey			Anderson	6/7/75	2+1
—		—			
Honi	6/7	1	KK	6/7/75	1
Anderson	6/7/74	1	Anderson	6/10/75	1
Vickrey	6/7/74		[illegible]	6/9/75	2
[illegible]	6/7/74		NCO	6/11/75	1

Safe Declarations Yes ☐ No ☐

Special Instructions/Explain high or low time charges below.

Safe Declarations Yes ☐ No ☐

Special Instructions/Explain high or low time charges below.

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R.W. Vickrey: ad **COPY—SAN FRANCISCO** Taxes

EXHIBIT SS-1

June 13, 1973

HAND DELIVERED
Barclays Bank International, Ltd.
111 Pine Street
San Francisco, California 94111

Attention: Mr. Robert E. Gilbert

Dear Sirs:

CALIFORNIA FRANCHISE TAX RETURN
YEAR ENDED SEPTEMBER 30, 1972

In accordance with your instructions, we have prepared and enclose, in duplicate, California franchise tax return for the year ended September 30, 1972 for Barclays Bank International, Ltd. showing a tax of $2,599 and an overpayment of $901, of which $850 will be credited to the revised third and fourth instalments of estimated tax or the year ending September 30, 1973 and $51 will be refunded.

The return has been prepared on the basis of reporting the world-wide income of Barclays Bank International and allocating a portion of that income to the California Agency according to the standard allocation formula for banks. As in prior returns, no detail of the world-wide income is provided in the return. Upon examination, an agent could request a more detail analysis of income and expense in arriving at the world-wide income of $98,749,473. Upon review and approval, the return should be filed in accordance with the instructions attached to the duplicate copy of the return.

CALIFORNIA DECLARATION OF ESTIMATED TAX
INCOME YEAR ENDING SEPTEMBER 30, 1973

We have reviewed the California estimated tax declaration and have prepared and enclose, in duplicate, a revision of the third and fourth instalments to reflect the overpayment mentioned above. Instructions for filing are attached to the duplicate copy of the declaration.

Yours very truly,

Enclosures—
Tax return
Declaration

EXHIBIT SS-2

June 7, 1974

Price, Waterhouse & Co.
555 California Street
San Francisco, California 94104
415-392-1032

HAND DELIVERED
Barclays Bank International, Ltd.
111 Pine Street
San Francisco, California 94111

Attention: Mr. Robert E. Gilbert

Dear Sirs:

CALIFORNIA FRANCHISE TAX RETURN
YEAR ENDED SEPTEMBER 30, 1973

In accordance with your instructions, we have prepared and enclosed, in duplicate, California franchise tax return for the year ended September 30, 1973 for Barclays Bank International, Ltd. (BBI) — California Agency showing a tax of $6,973 and an overpayment of $7,027.

The return has been prepared on the basis of reporting the worldwide income of Barclays Bank International, Ltd. and allocating a portion of that income to the BBI — California Agency according to the standard allocation formula for banks. As in prior returns, no detail of the worldwide income is provided in the return. Upon examination, an agent could request a more detailed analysis of income and expense in arriving at the worldwide income of $84,793,923. In addition, the following items regarding the determination of the California Agency allocable income should be noted:

1. The California Franchise Tax Board (FTB) may assert that pre-tax profits as outlined by the Barclays International Group consolidated profit and loss report should be used in determining worldwide net income rather than the "grossed-up" after-tax net income total which was provided by your London office and was utilized in the tax return calculations.

2. The resources factor was calculated without consideration of the following items as the worldwide information was not available:

a. The Reserve for loan losses was deducted in arriving at total resources although normal practice would be to exclude it.

b. The rent factor (8 × rents) was not included as an addition to total resources, although normal practice would be to include it.

In addition, the FTB may assert that property should be stated at original cost exclusive of depreciation, including fully-depreciated property still in use. At present, the property used in the resources calculation is stated at book value which apparently includes some revaluation.

3. The BBI — California Agency resources during the year ending September 30, 1973 increased from a beginning balance of $1,764,238 to an ending balance of $22,681,566 due to large loans carried on the Agency's books. If these loans had been carried on the books of a non-California BBI branch causing resources in the BBI — California Agency to remain relatively constant during the year, the California tax liability of the Agency would have decreased approximately $3,000.

4. As discussed with you, we have treated salaried personnel charged against the BBI — California Agency operations as employees of Barcal. Accordingly, for purposes of the allocation factor calculations these salaries are included as "management fees" and no salaries are listed for the Agency.

CALIFORNIA DECLARATION OF ESTIMATED TAX
INCOME YEAR ENDING SEPTEMBER 30, 1974

We have reviewed the requirements of BBI — California Agency for paying California estimated tax payments for the year ending September 30, 1974 and have determined that no additional payments are required. The estimated tax payments made with Vouchers 1 and 2 ($8,000) are already in excess of the prior year's tax liability.

Upon review and approval, the return should be filed in accordance with the instructions attached to the duplicate copy of the return.

Yours very truly,
PRICE WATERHOUSE & CO.

Enclosure—
Tax return

Price
Waterhouse & Co.

EXHIBIT SS-3

June 10, 1975

Price,
Waterhouse & Co.

555 California Street
San Francisco, California 94104
415-392-1032

HAND DELIVERED

Barclays Bank International, Ltd.
111 Pine Street
San Francisco, California 94111

Attention: Mr. Robert E. Gilbert

Dear Sirs:

CALIFORNIA FRANCHISE TAX RETURN
YEAR ENDED SEPTEMBER 30, 1974

In accordance with your instruction, we have prepared and enclose, in duplicate, California franchise tax return for the year ended September 30, 1974 for Barclays Bank International, Ltd. (BBI) — California Agency showing a tax of $26,671 and an unpaid balance of $691 which includes interest of $20.

The return has been prepared on the basis of reporting the worldwide income of Barclays Bank International, Ltd. and allocating a portion of that income to the BBI — California Agency according to the standard allocation formula for banks. As is prior returns, no detail of the worldwide income is provided in the returns. Upon examination, an agent could request a more detailed analysis of income and expense in arriving at the worldwide income of $139,279,400. Other items regarding the determination of the California Agency allocable income which should be noted are as follows:

1. The California Franchise Tax Board (FTB) may assert that pre-tax profits as outlined by the Barclays International Group consolidated profit and loss report should be used in determining worldwide net income rather than the "grossed-up" after-tax net income total which was provided by your London office and was utilized in the tax return calculations.

2. The resources factor was calculated without consideration of the following items as the worldwide information was not available:

a. The Reserve for loan losses was deducted in arriving at total resources although normal practice would be to exclude it.

b. The rent factor (8 × rents) was not included as an addition to total resources, although normal practice would be to include it.

In addition, the FTB may assert that property should be stated at original cost exclusive of depreciation, including fully depreciated property still in use. At present, the property used in the resources calculation is stated at book value which apparently includes some revaluation.

3. Personnel salaries have been charged against the BBI — California Agency operations as salaries of employees of Barclay. Accordingly, for purposes of the allocation factor calculations these salaries are included as "management fees" and no salaries are listed for the Agency.

CALIFORNIA DECLARATION OF ESTIMATED TAX
INCOME YEAR ENDING SEPTEMBER 30, 1974

We have reviewed the requirements of BBI — California Agency for paying California estimated tax payments for the year ending September 30, 1975 and have determined that estimated tax payments totaling $26,700 should be made. The revised deposits due are summarized on the enclosed instructions for payment.

Upon review and approval, the return should be filed in accordance with the instructions attached to the duplicate copy of the return.

Yours very truly,
PRICE WATERHOUSE & CO.

Enclosure—
Tax return

Price
Waterhouse & Co.

EXHIBIT TT

June 15, 1973

Barclays Bank International
111 Pine Street
San Francisco, California 94111

Attention: Mr. Robert Gilbert,
Controller
06915

Services rendered from June 16, 1972
through June 15, 1973 in connecion [sic] with:

The preparation of the California franchise tax return for the year ended September 30, 1972;

Preparation of the California declaration of estimated tax for the year ending September 30, 1973; and

Sundry tax and accounting assistance— $1,250

R.W. Vickrey:aw

June 18, 1974

Barclays Bank International, Ltd.
111 Pine Street
San Francisco, California 94111

Attention: Mr. Robert E. Gilbert

Services rendered through June 15, 1974 in connection with:

1. The preparation of the California franchise tax return for the Agency for the year ended September 30, 1973;
2. Review of required estimated California franchise tax payments for BBI for the year ending September 30, 1974;
3. Review and assistance with correspondence with the London home office and the Franchise Tax Board agent regarding combined unitary accounting; and
4. Sundry tax and accounting assistance— $900

J.E. Ullakko:aw

June 18, 1975

Barclays Bank International, Ltd.
111 Pine Street
San Francisco, California 94111

Attention: Mr. Robert Gilbert,
Controller

Tax and accounting services rendered from June 16, 1974 to June 15, 1975 in connection with the following:

Preparation of the California applications for extension of time within which to franchise tax returns for the year ended September 30, 1974;

Preparation of the California franchise tax return for the Agency for the year ended September 30, 1974;

Review of required estimated California franchise tax payments for BBI for the year ending September 30, 1975;

Consultation and assistance regarding the Franchise Tax Board's examination of BBI's franchise tax returns for the years ended September 30, 1969 through 1973;

$1,100

EXHIBIT UU

June 17, 1977

VT BUFFalow/mjp

Barclays Bank International, Ltd.
111 Pine Street
San Francisco, California 94111

Attention: Mr. Robert Gilbert

Tax and accounting services rendered from June 16, 1976 to June 15, 1977 in connection with the following:

Preparation of the California application for extension of time within which to file franchise tax returns for the year ended September 30, 1976;

Preparation of the California franchise tax return for the Agency for the year ended September 30, 1976;

Review of required estimated California franchise tax payments for BBI for the year ending September 30, 1977; and

Consultation regarding sundry tax and accounting matters—

$1,400

T.E.BISHOP/jcr

June 29, 1978

Invoice No. 1143-06915-015

Barclays Bank International, Ltd.
111 Pine Street
San Francisco, California 94111

Attention: Mr. Robert Gilbert,
Senior Vice President
and Controller

Tax and accounting services rendered from June 16, 1977 to June 15, 1978 in connection with the following:

Review of the California franchise tax return for the Agency for the year ended September 30, 1977

Review of required estimated California franchise tax payments for BBI for the year ending September 30, 1978;

Research and consultation regarding tax planning alternatives with respect to the boarding of loans in New York or in California; and

Consultation regarding sundry tax and accounting matters— $925

EXCERPTS OF GEORGE N. CARLSON

* * *

[p. 48] having been first duly sworn according to law, upon his oath testified as follows:

DIRECT EXAMINATION

BY MS. IRION:

[p. 62] Q. Mr. Carlson, during your tenure at Treasury, did you observe that there was an effort by the United States to further promote uniform rules to divide the income of multinational businesses among separate taxing jurisdictions?

A. Yes, I did.

* * *

Q. Did other nations try to do the same thing?

A. To—the same thing being to promote?

Q. The promote uniform rules—

A. Yes.

[p. 63] Q. —to divide the income?

A. Yes, they did.

* * *

Q. Are you aware of the reasons for this effort among the various nations?

A. I believe it—yes, I am.

Q. And what is that reason or reasons?

A. It's an understanding that in the world economy—and by that, I mean an economy that extends beyond the borders of any particular country—that generally speaking, the free flow of goods and services and investment income is a desirable objective in the sense that it increases overall economic welfare, as it were, and that free trade, for example, is a good thing.

Obviously, there are exceptions to this view in cases of embargoes on certain items for national security items or things like

that. But absent such exceptions, the economic rules ought to be such that there can be free [p. 64] movement of goods and investment capital, and a recognition as part of that that taxes can serve as barriers to trade or investment just as much as tariffs can, and that it's important to have common rules between two countries or among the countries so that those barriers can be reduced an perhaps eliminated.

Q. When you joined Treasury, did you learn that there was a United States policy to promote free trade?

A. Yes. That's, I think, fairly standard policy in most administrations, and President Reagan, for example, in this administration has proclaimed the virtues of free trade and free movement of international investment, and most of his predecessors have as well.

Q. Did you also see a policy of tax harmonization, Mr. Carlson?

A. Yes.

* * *

Q. (By Ms. Irion): Mr. Carlson, could you perhaps explain that?

A. I—by tax harmonization, I assume you mean that countries of the world talk to each other and meet and agree on rules of taxation that affect, for example, two countries. If investment is moving from one country to another country, how is the income from that investment going to be taxed?

[p. 65] Harmonization in the sense of a clear understanding of what the rules are, and also, harmonization in the sense that the rules are similar among the developed countries of the world.

* * *

[p. 68] Q. Now, when you were a member of the OECD Fiscal Affairs Transfer Pricing team, was there consideration of the use of the global method of taxation?

A. Yes, there was.

Q. And that, as you said earlier, is essentially the same as worldwide combined reporting?

A. That's correct.

* * *

[p. 69] Q. What was the reason for the discussion, Mr. Carlson?

A. The objective of the OECD Transfer Pricing group was to specify rules for valuing and transfer prices and also for determining the income of multinational corporations, and since worldwide combined reporting—or what the OECD called the global method—can or is viewed by some as an alternative to the separate accounting principle, the group felt that it was appropriate to consider whether the global method could be used as a method in arriving at income on a separate accounting basis, or if not, whether or not it would be an acceptable substitute for the separate accounting method.

Q. What were the results of those deliberations?

A. Based on the discussions at the OECD meetings, the committee members felt that the global method was not an acceptable method of determining the income of related corporations, multinational corporations, nor did it feel that it was consistent with the separate accounting or arm's-length method. They did not view it as a reasonable alternative to the separate accounting method either.

So that for all those reasons, the committee decided to reject global or worldwide combined reporting as a method of multinational taxation. I believe that finding was—or is reflected on the OECD's 1979 report.

* * *

[p. 75] Q. Now, Mr. Carlson, during your employment with Treasury, did you get complaints about the states' use of worldwide combined reporting?

A. The—yes, the Treasury received them, and I as a Treasury employee saw the complaints.

Q. All right. When —

A. Excuse me. I also received complaints directly. In the sense "received," was asked to meet with official from foreign governments who were with the economic attaches stationed as an economic officer in the embassy at Washington D.C., the economic or Treasury representatives of a particular country, and met with those people directly.

Q. When, to your knowledge, was the first time that Treasury started receiving complaints about the states' use of worldwide combined reporting?

A. In the early 1970s.

Q. Was this during the Nixon and Ford administrations?

A. Yes.

Q. Do you know the reasons why the complaints [p. 76] didn't start until then?

A. I believe that there was not a problem that was identified with respect to worldwide combined reporting. The—it wasn't until the early 1970s that it was—that combined reporting was applied on a worldwide basis, or at least applied on a worldwide basis with sufficient frequency and reach that it began to raise concern on the part of our foreign trading partners.

* * *

Q. How did the foreign government businesses and trade groups complain?

A. The—frequently, there would be a—a letter sent to Treasury officials, such as the Secretary of the Treasury or the Assistant Secretary for Tax Policy, from a foreign business group or from a trade association. Diplomatic notes from foreign countries were another vehicle of—those notes would be delivered either in mail or by person by the economic official attached to the embassy of that country in Washington.

[p. 77] Notes from the European Economic Community, which is made up of primarily Western European countries, were also received with a great deal of frequency. I believe between May of 1980 and September of 1983, the Treasury Department

received five separate notes from the European Community objecting strongly to the states' use of worldwide combined reporting.

The U.S. State Department would also forward to the Treasury Department representations and notes and objections that had been given to the State Department from departments from a foreign government.

So there were many, many ways in which the complaints were known. And then, as I indicate also, by personal visits where perhaps a member of the business community or trade association—excuse me, trade association or official of foreign governments stationed in Washington would object to the Treasury about this.

I also met, for example, with members of the British Parliament on this who were concerned about this.

Q. Now, these notes that you referred to, are they also referred to as "demarches"?

A. I believe that's the correct word, yes.

Q. Did you also have meetings with representatives from the government of Japan about complaints associated with the states' use of worldwide combined reporting?

A. Yes. The government of Japan, government of Canada, the government of the United Kingdom, the government of the Netherlands, all had meetings. I—I was personally [p. 78] involved with meetings of the officials of all of those governments.

Often, on more than one occasion on this issue, and there was a common theme or thrust to these meetings, and that was that these other countries were very concerned about the states' use of worldwide combined reporting and implored the administration to end it.

Q. While you were at Treasury, did the number of these complaints increase?

A. Yes.

Q. Did the intensity of these complaints increase?

A. Yes. The—as I mentioned, the—between March of 1980 and the fall of 1983, there were five separate notes from the European Community. Then in September of 1983, Prime Minister Trudeau from Canada sent the Treasury Department a letter strongly objecting to worldwide combined reporting which we found was—was found to be quite interesting in light of the fact that Canada, of course, has a federal system of government like we do. They have provinces which are equivalent to our states.

And the letter indicated an awareness of this, but also a feeling that worldwide combined reporting was creating serious international problems, and the prime minister—the letter was referred to the Treasury, although the letter itself was sent to the President of the United States to try to solve the problem.

Q. Mr. Carlson, to your knowledge, were heads of state discussing this issue?

[p. 79] A. Yes. The—this is an issue that—that after 1980, was raised at meetings that President Reagan would have with—after 1981, with the heads of state.

When the President would meet with Prime Minister Thatcher of Great Britain, for example, this was an issue that came up and was discussed. This is something that—that was talked about between both of them.

In the fall of, again, October or November, of 1983, not at the head of state level, but the financial minister level, financial administrative level, Secretary—I'm sorry, it was in the fall of 1985—Secretary Baker was going to meet with Mr. Takishida who is the prime—the finance minister of the government of Japan, and expected that the number one item on the issue — the number one issue on the agenda would be the global debt issues and debt problems with less-developed countries. But Mr. Takishida raised the worldwide combined reporting issue first and foremost—first and foremost with Secretary Baker.

Q. How are you aware of this, Mr. Carlson?

A. The—some of these events that I just described were mentioned in the press, in the financial press, and Business Week and that kind of thing.

Others, I was aware of through working in the government. And that would happen in the following way: When a meeting was to be held with a head of state or between the Secretary of the Treasury and his counterpart in another country, we would be asked to prepare briefing material on tax issues, and there was never in this period, '82, '83, [p. 80] '84, '85—never a meeting in which we were not asked to prepare something on the worldwide combined reporting issue, so the expectation was that it would come up frequently, and we would learn later the extent to which it was discussed because there would be some report back as to what transpired at the meeting.

Q. Mr. Carlson, based upon your work at Treasury before the mid 1970s, had state taxation ever been an international issue?

A. Not that I'm aware of.

Q. Were several pieces of federal legislation dealing with state taxes introduced into Congress in the late 1960's and early 1970s?

A. I believe the were.

Q. Now, did any of these bills deal solely with the issue of the combination of the overseas income of foreign multinational entities?

A. No. They — did not deal solely and exclusively with the combination of the income of a foreign-based multinational.

In fact, they were quite broad in the sense that they dealt with multistate tax issues in many cases that didn't touch directly on the foreign parent.

* * *

[p. 83] Q. (By Ms. Irion): Mr. Carlson, then, to your recollection, the 1970's was the first time that Treasury received and considered international complaints about state taxation?

A. Internationally that's correct, yes.

Q. What were the complaints that Treasury was referring about the states' use of worldwide combined reporting?

A. Well, first of all, the complaints were addressed specifically to worldwide combined reporting. I'm not aware of any foreign complaints on any other state tax issue. So that's — that was the issue that concerned them.

And they objected strongly to states use of worldwide combined reporting for a other [sic] number of reasons.

Q. What were those reasons?

A. They state—excuse me, the foreign governments felt that worldwide combined reporting was unreasonable because it gave rise to double taxation in the international arena; that it was inconsistent with the separate accounting or arm's-length standard that's reflected in the OECD transfer pricing report, and the OECD Model Treaty, and the network of bilateral tax treaties that the United States has with these countries.

[p. 84] They felt it was inconsistent with that. They felt that it was an administrative burden on corporations, foreign-based corporations, that had to comply with worldwide combined reporting. And generally, they indicated that in their view, it was creating a foreign policy problem in the sense that they viewed the states as following a foreign commerical [sic] policy which was divergent from that that was followed by the Federal Government.

Q. Did Treasury do an investigation of these complaints by foreign governments and foreign businesses?

A. Yes, they did.

Q. What did they do?

A. Well, they—it's somewhat similar to what I mentioned earlier about how policy decisions were reached. The complaints were investigated thoroughly and worldwide combined reporting, for example, was studied to identify precisely how it differed from the separate accounting standard. And given that it differed, what effect it had on a foreign corporation doing business in the United States.

And Treasury compared that method with the system of taxation both that the United States and the foreign countries

follow. And Treasury also looked at the extent to which it—this was—tried to determine the extent to which this diverged from the separate accounting standard.

MS. IRION: Your Honor, just for your information, the exhibit number that I was referring to with respect to the Task Force is 37-A, of the First Stipulation of Facts.

THE COURT: Thank you

[p. 85] Q. (By Ms. Irion): Mr. Carlson, did Treasury do any investigation of the complaints of foreign governments that use of the worldwide combined reporting system resulted in international multiple taxation?

A. Yes.

Q. And based upon Treasury's independent investigation, did Treasury find that the complaints were true?

A. Based on their—based on Treasury's study and analysis of the issues, a conclusion was reached—a conclusion was drawn, and that conclusion was that state use of worldwide combined reporting gave rise to an increased risk of double international taxation, and that accordingly, the complaints of the foreign governments on this point had a good deal of merit.

Q. What did Treasury base this upon?

A. What did Treasury base this conclusion on?

Q. This conclusion upon.

A. It was based on comparing the operation of the two methods, as I indicated earlier, under the separate accounting method, the taxable income of two corporations incorporated in different countries, even though they are related, even though one—by "related," I mean even though one may own the other or they may be owned by somebody else, the taxable income is determined separately. And then once that determination is made, a—the country in which the corporation is incorporated is allowed to apply its tax rules to that corporation's income to determine how much it's going [p. 86] to tax. Worldwide combined reporting, in contrast, as I indicated earlier, looks beyond a

single corporation to all corporations wherever incorporated, wherever they are doing business and taxes a uniform percentage or proportion of the income of all those corporations, and accordingly, it was inescapable that there was a risk of—increased risk of international double taxation because the income that was subject to tax under separate accounting in one country was also being taxed on a proportion of the formula basis under worldwide combined reporting.

Q. Did Treasury find that double tax was inevitable with the use of the system of worldwide combined reporting in conjunction with the international separate entity arm's length standard?

A. Yes, because they're two distinctly different methods and because not only the United States, but other countries, were taxing the income of corporations separately.

Another system superimposed on top of the separate accounting system that taxed a uniform percentage of the income of each and every corporation, wherever they are located, undeniably gave rise to risk of double taxation in the sense that the income that was subject to tax under separate accounting was also being subject to tax under worldwide combined reporting.

Q. Did treasury investigate the claims of administrative burden of foreign businesses?

A. Yes, it did.

Q. Based upon Treasury's investigation, did they [p. 87] find the claims of foreign multinationals that worldwide combined reporting was administratively burdensome to be true?

A. Yes, it did.

Q. Can you explain what Treasury's findings were based upon?

A. It was based on, again, a study of how worldwide combined reporting operates and a realization that for the purposes of being taxed on a worldwide combined reporting basis, a taxpayer would be required to report their income and business activities on a worldwide basis, assuming that it's all part of a unitary business, and this kind of a report, that is reporting the income

and business activities on a worldwide basis with respect to a foreign-based multinational doing business in the United States, is not required for either U.S. or Tax purposes nor is it required by any other country.

So that based on this conclusion that worldwide combined reporting required substantially more information than would be required even for U.S. Federal tax purposes, Treasury reached its conclusion that there was a compliance —that there was an administrative burden problem, and again, therefore, that the foreign complaints had merit.

Treasury, in particular, I believe, was troubled by the fact that it wasn't just a matter of collecting the information, but that in some cases, the corporation subject to tax may not even be able to get the information, may not [p. 88] have access to it. So it was asking for something that in some cases it was possible to provide and in other cases, impossible.

* * *

[p. 89] Q. Did Treasury investigate the claims of the foreign governments that the states' use of worldwide combined reporting was an irritant to international relations with the United States?

A. Yes, it did.

Q. And what was the result of that investigation?

A. The Treasury examined that complaint, and again, based on how worldwide—based on first analyzing exactly how worldwide combined reporting operates, what its effects are, comparing it with the separate accounting system, Treasury was able to arrive at a conclusion that worldwide combined reporting was markedly different from the separate accounting system followed by the United States and by the other countries of the world. Most pointedly in the sense that income of a foreign corporation not doing business in the United States is subject to tax under worldwide combined reporting, is not subject to tax under separate accounting, and that this was viewed by the foreign governments, by foreign trading partners, as a departure from international rules and, as evidenced by their objections, both

written and oral, was an irritant in our foreign commerce relations with these countries.

Q. Did the foreign governments complain that the states' use of worldwide combined reporting was directly [p. 90] affecting them as a governments?

A. Yes, they did.

Q. And how was that?

A. They—they were—as I've indicated, the foreign governments complained directly to the Treasury Department, and they made it clear that they had concerns of their own separate and distinct from those of businesses located in there United States. They were troubled by the fact that there could be a situation, such as was given rise by the states' use of worldwide combined reporting, where foreign business was subject to tax under different rules than the other countries of the world, and the United States followed. They found it—indicated to us that they found it somewhat embarrassing that—that another country should have that—excuse me, that a state could have tax rules that were different than the—different than the international rules.

So they were bothered from that standpoint. They were also bothered from the standpoint that they viewed worldwide combined reporting as giving rise to double taxation, and as I indicated before, based on a study, Treasury found merit to that complaint. And the significance of that for the foreign government, it was that—that when that income was taxed under worldwide combined reporting then it was less—less money left over for the foreign investor or for the foreign government. That is, that because of the higher tax imposed, for example, by the State of California that less money on foreign investment paid from the United [p. 91] States back to Britain, for example, would be available to be shared between the foreign government and the foreign business. So that they viewed this as something that they were very concerned about.

Q. Mr. Carlson, were you aware of whether representatives of these foreign governments met with officials of several states about the states' use of worldwide combined reporting?

A. Yes, I—yes, I am aware.

Q. All right. And did they do so?

A. Yes, they—yes, they did.

Members of the government of Japan and government of the United Kingdom met with state officials in California. This was something that—and in other states.

John Moore, for example, who is the—or was in July of 1985 the Financial Secretary to the British Treasury made a speech to the House of Commons in which he said—and this was just prior to a vote on some antiunitary legislation they were considering, and Mr. Moore said, "Before we vote on this, we should ask ourselves whether we've done everything possible to solve the problem."

And then he asked this question rhetorically, he said that "I believe we have talked to the Federal Government ad nauseum about it, but we also talked to the states," and this being July of 1985, Mr. Moore indicated that the officials from the British Government had been to North Dakota. Utah, Colorado and Florida and four separate times to California.

So that this was something that we were aware of was [p. 92] happening and was also an issue of some concern within the Treasury Department because we felt that foreign commercial relations are something that ought to be handled on a nation-to-nation basis and that—sub-federal units of government should not be involved in that.

Q. Why was there concern on the part of Treasury, Mr. Carlson?

A. Because of the feeling that the United States Government should be the party—that the Federal Government should be the party that deals with other countries, rather than other states.

* * *

Q. Now, Mr. Carlson, was the Federal Government having any difficulties because of the states' use of worldwide combined reporting?

A. The—yes.

Q. And what were those difficulties?

[p. 93] A. Well, it was receiving a great deal of, as I've indicated, complaints, representations, concerns from foreign governments, and the foreign governments were concerned that their share of international investment was being reduced by the states' use of worldwide combined reporting. They also felt that they were in an embarrassing position because their taxpayers were subject to rules that were different than the international standard, and accordingly, they—as I've indicated—complained directly to the Treasury Department, and that created problems for the Federal Government.

Q. Was the states' use of worldwide combined reporting interfering with the United States' policy?

A. Yes, I believe it was.

Q. And how was that?

A. Well, it was in the sense that there was a state tax system that, as I've explained, through the way it worked, and because of the fact that it's markedly different than separate accounting, which is what the United States and the other countries of the world use, that this was interfering with the kind of foreign commerce policy that we talked about earlier, establishing rules of harmonization and establishing rules that encourage relatively free flow of investment capital.

It was viewed—the looking—as foreign governments looked at us, they sometimes questioned whether we had one foreign policy or fifty-one different foreign policies. And this is something that was of great concern to both the Treasury Department and State Department because [p. 94] those branches—those portions of the Executive Branch feel that they are in charge of those responsibilities.

Q. Was the states' use of worldwide combined reporting embarrassing for the national government?

A. Yes, it was, in the sense that the foreign governments found it very difficult to understand how there could be a situation where a state could pursue a tax policy that had international ramifications, international ramifications that were at odds with

what the rules of the United States and the other countries followed.

This is something that time and again in meetings with foreign government officials I was asked the question, "How can you—how can this happen in your system of government?"

Q. Mr. Carlson, was the states' use of worldwide combined reporting interfering with the ability of the United States to negotiate bilateral treaties?

A. Yes, it was.

Q. And how was it doing that?

A. Well, again, because foreign governments were so sufficiently agitated over this problem that they were reluctant, and expressed their reluctance—the government of the Netherlands told us this. Germany told us this—to conclude a bilateral tax treaty unless they could have some assurance that the Federal Government could solve the problem.

And this gets back to the issue we were talking about a minute or two ago that the reason that the foreign [p. 95] governments felt that they—they in turn found it embarrassing or troublesome that there would be a situation where their businesses doing business in this country could be put at substantial tax risk because of a system that was different from what they used and what the United States used.

* * *

Q. Did Treasury have a policy concerning the use by the states of worldwide combined reporting as it applied to foreign multinational business?

A. By "foreign multinational business," again, you mean a corporation incorporated in another country outside the United States?

Q. Yes, Mr. Carlson.

A. Yes, Treasury did have such a policy.

Q. What was that policy?

A. The policy was, and is, that worldwide combined reporting ought not to be applied to foreign-based multinational corporations.

Q. And when was the first time that this policy was formulated, to your recollection, in Treasury?

A. That would be in connection with the United States-United Kingdom Income Tax Treaty which was signed December 31st, 1975. Although, since it was a treaty, of course, it had to be considered by the Senate, and the deliberations on that were not until two or three years later.

I'd put December 31st, 1975 as the initial time.

Q. And did the U.S.-U.K. Treaty as originally [p. 96] negotiated include a provision known as 9(4)?

A. Yes, it did.

Q. And what would that provision have done?

A. That was a provision that would have prohibited the states from applying worldwide combined reporting to a United Kingdom-based multinational corporation.

* * *

[p. 104] Q. What was the reason that the Treasury had drawn this distinction between the application of worldwide combined reporting as to foreign multinationals' businesses [p. 105] as opposed to domestic?

A. It was a judgment based on the analysis of the issue and the problem that—the problems that we have touched on of interference with foreign commercial policy, with treaty negotiations, of double taxation, with administrative burden, a potential of retaliation; all these things applied with full force to the case of the foreign-based multinational. It did not apply in all cases to the U.S.-based multinational. They were—some of these problems, in other words, were unique to the case of the foreign-based multinational, and accordingly, that was the reason for drawing this clear and unmistakable distinction in the testimony that worldwide combined reporting should be prohibited for foreign-based

multinationals and the same with respect to being less certain with respect to what the solution should be for U.S.-based multinationals.

* * *

[p. 167] Q. Mr. Carlson, at this time, did the Treasury believe as long as any state was using worldwide reporting that there would be a problem with the foreign trading partners?

A. This is in August of 1985?

Q. Yes, Mr. Carlson.

A. Yes.

* * *

[p. 193] Q. The difficulties caused for the United States were and always had been connected with the use of worldwide combined reporting as it applied to foreign-based multinationals; is that true Mr. Carlson?

A. In dealings with other countries, yes.

* * *

CROSS EXAMINATION

BY MR. MILAM:

[p. 214] Q. To the extent that a United States bilateral income tax treaty might differ from the OECD Model, the bilateral sets the rule of the United States; does it not?

A. That's correct, if the United States has a treaty with another country, and that describes and explains how income of the treaty partner earned in the United States will be taxed by the United States or how income earned by a U.S. resident or corporation in the country of the treaty partner would be taxed.

Q. Well, isn't it true that most United States [p. 215] treaties—income tax treaties affect only Federal taxes except for the purposes of nondiscrimination?

A. Again, we are talking income tax treaties, Mr. Milam?

Q. Income.

A. Yes. The U.S.—the income tax treaties which the United States has with other countries cover the U.S. federal income tax. They do not cover subfederal taxes.

* * *

[p. 226] Q. (By Mr. Milam): And later, isn't it true that the entire treaty was passed, except for 9(4), ratified by the U.S. Senate?

A. No, I don't believe that's exactly right Mr. Milam. The treaty was passed—ratified by the United States Senate with a vote of 82 to 5 with a reservation regarding the application of 9(4) to subfederal units of government.

The effect of the reservation was to merely reserve—merely exclude that provision from the treaty. So the 82 to 5 vote can only be interpreted as a vote on the treaty. The—a reservation is not a rejection of policy. It is merely excluding something from the treaty.

After all, there were many other issues that the treaty didn't cover, such as state and local sales taxes or estate and gift taxes, and the fact that these items were not [p. 227] included in the treaty certainly cannot be viewed as a rejection of administration policy in that area.

The effect of the reservation was simply to remove that provision from the treaty, but it was not a statement of congressional policy.

Q. Since the Senate reservation of 9(4) and ratification—subsequently, ratification of the U.S.-U.K. Treaty, has the Executive Branch of the United States negotiated another treaty with that same provision in it? That is, the provision as 9(4).

A. As applied to subfederal units of government, Mr. Milam?

Q. Yes. Yes.

A. No, it has not.

Q. And do you know the reason that the Executive Branch has not negotiated the treaty with that provision?

A. It's sought to resolve the issue in other ways; such as through judicial proceedings and the Working Group and Federal legislation. It sought to resolve it through other vehicles.

* * *

[p. 236] Q. Did you explain to them the nature of our Federal governmental system?

A. Yes, I did. The nature of our Federal governmental system was an issue that came up time and time again in discussions with foreign trading partners because [p. 237] they had a difficult time understanding how a state could have its own foreign policy.

Q. And what did you tell them with respect to our Federal system?

A. That individual states had the right to impose certain taxes absent creating major problems, and that if a significant problem had been created and we, the administration, agreed with it, or the Executive Branch agreed with it after analysis, that we would see what could be done about it.

But, as with the Working Group recommendations, if it's going to be adopted at the state level, that's up to the state legislature and the governor in a particular state.

Q. And what did you tell them Federal Government could do about it?

A. About encouraging a change of state law, for example?

Q. About changing state law.

A. We indicated that we could encourage the states to change their state law, as we had all along, and that if that did not happen, that the administration was prepared to recommend Federal legislation to restrict state law as far as applying worldwide combined reporting to foreign-based corporations.

* * *

[p. 244] Q. To your knowledge, is California's use of the worldwide combined reporting method prohibited by the U.S.-U.K. Treaty?

A. It's not prohibited by the treaty. It's not covered by the treaty.

It's not covered by the treaty; therefore, it's not prohibited by the treaty.

Q. To your knowledge, is California required to use separate accounting by the U.S.-U.K. Treaty?

A. Because the worldwide combined reporting is not covered by the U.S.-U.K. Treaty, there could be no requirement to use separate accounting, which of course, is the international-accepted alternative to worldwide combined reporting.

* * *

[p. 276] Q. In the Working Group Report and the recommendation of the Task Force, wasn't there acceptance of the fact that in certain circumstances the states could use worldwide combination?

A. I believe that's correct.

Q. And under what circumstances could they use worldwide combination?

A. That, of course, would be an exception to the basic recommendation of the Working Group. I believe one exception was that if a spread sheet or disclosure document had not been filed with the Internal Revenue Service—this was a document that was related to the second Working Group recommendation—that in that case, if the—in other words, if the taxpayer had not lived up to recommendation 2 in the Working Group, then in that case, the state would not be bound by—could apply worldwide combination.

Q. Was it basically a failure to provide information? Is that what you are talking about?

A. I believe that it referred to the information that was going to be provided or provided for under the second recommendation of the Working Group, not providing that specific information.

EXCERPT DEPOSITION READ INTO THE RECORD OF DONALD M. MARNACH

* * *

[p. 351] "Q. So in order to make the adjustments, if you are a foreign parent company with affiliates in several countries, would you have to make depreciation schedules for assets located or owned by the affiliates of those various countries according to U.S. or California schedules?

A. If you wish an adjustment to be made, other than to your book depreciation, yes, and that would—I would think would depend on whether or not you felt the adjustment was material."

[p. 352] "Q. If a U.K. parent company wished to obtain—take advantage of the depreciation allowances under the California unitary return, they would have to either develop schedules for the devaluation and depreciation under California [p. 353] and U.S. accounting purposes from all of its affiliates or have that information be furnished to them; would they not?

A. For California purposes; not necessarily need the United States—"

* * *

"Q. All right. But they would need schedules for California for each of its affiliates all around the world; is that correct?

A. If they chose to have an adjustment to their book depreciation, yes."

* * *

"Q. So, if they operated in 70 countries around the world, they would have to have depreciation schedules on the California basis for essentially 70 countries; is that true?

A. If they chose to have the depreciation adjustment, assuming that they deemed that the depreciation was a material item to worry about, yes."

* * *

[p. 354] "Q. Okay. I think I understand with respect to the bad-debt reserve. If a foreign parent company with foreign affiliates in over 70 countries was to take advantage of the California bad debt reserve, what information would they need to do that?

A. Well, they need to know their loan base, which they had—I would expect have for consolidated loan purposes that shows the amount of their receivables."

* * *

"Q. And then they would have to know where those—how those rules differed from the bad debt reserve rules in the [p. 355] country in which the affiliates were operating as well as the parent company; is that true?

A. Yes."

* * *

"Q. All right. Now, once they have that information, what do they do with it if they really want to take advantage of California bad debt reserve rules?

A. They establish—well, their financial statements essentially are going to have to show their amount of receivables. They would have to know how much was—were charged off over a number of years."

* * *

"Q. Okay. And that's with respect to loans made by affiliates in each of the 70 countries; is that correct?

A. Yes."

* * *

[p. 356] "Q. With respect to adjustment—LIFO adjustment in particular industries, again, would adjustments have to be made from the accounting conventions used in the host country—the country in which an affiliate is operating—to the conventions used in the United States or California in order to take advantage of the LIFO rules, if applicable?

A. Yes."

* * *

"Q. Okay. So that would mean preparation of schedules in accordance with California rules by each of the affiliates operating around the world; is that correct?

A. Yes."

* * *

"Q. So, if you had affiliates operating in over 70 countries, they would need to prepare 70 different schedules according to the California method; is that correct?

A. If they did not use LIFO for book [p. 357] purposes and they chose to get the benefits of LIFO for California tax purposes, yes."

* * *

[p. 358] Question: "Well, assuming that the affiliates of a unitary business did not use LIFO, did not depreciate assets, didn't have reserves computed into the California method, and they didn't typically convey this information to their parents, and if they wanted to take advantage of the California rules, they would essentially have to have accounting systems set up under California rules and regulations or

make adjustments to their rules under the California method in order to take advantage of California [p. 359] Unitary regulations; isn't that true?

A. They would have to either—either set up schedules or develop a system that would satisfy the auditor or the administrative relief procedures that they are entitled to adjustment, yes."

EXCERPT DEPOSITION READ INTO THE RECORD OF HOWARD G. VANDEBERG

* * *

[p. 365] "Q. So that there was expansion of investment by United States companies in the foreign markets, and conversely, by foreign businesses in the United States market, between '75 and—in the mid-70's?

[p. 366] A. Yes. Companies were going from a national concept to multinational concept, becoming world companies rather than national companies."

* * *

"Q. In this period, there began to be some concerns expressed by certain taxpayers with respect to the feasibility of complying with California unitary on a worldwide basis, certain complaints that were raised at this point time; isn't that true?

A. Yes."

* * *

"Q. One of the reasons that you were hearing the complaints at this point in time—when the California unitary theory had been in practice for several years—was that this was really the first period of time that the unitary concept had been expanded offshore and basically because the operation had increased?

A. I think it was probably one of the [p. 367] first times they became exposed to this particular requirement that they

report on a worldwide basis because they expanded within this country."

EXCERPTS OF WILLIAM MICHAEL JOHN GRYLLS

* * *

[p. 399] having been first duly sworn according to law, upon his oath testified as follows:

DIRECT EXAMINATION

BY MR. JORDAN:

[p. 410] Q. (By Mr. Jordan): Let me start all over.

In evidence in this case, and for your information, it's Exhibit 81, is the U.K. brief filed as a friend of the court in this very litigation.

In that statement—in that brief, the United Kingdom has stated that "The application of the California method of taxing income of foreign multinational corporations doing business in the United States offends the major trading partners of the United States," and that's at Page 7 and 8 of the brief.

My question is: Mr. Grylls, did your investigation as a member of this committee and as a member of Parliament and your discussions with these corporations, these major British corporations, substantiate with you what I read to you from the U.K. brief?

A. It did.

Q. Can you explain what you found out as a member of this committee in relationship to these complaints of these British corporations?

A. Yes. We did not just accept their word that they were unhappy with the form of taxation that we are discussing superficially. We investigated it very carefully with them, and to that extent, it was firsthand knowledge rather than hearsay.

[p. 411] And we have many people, your Honor, who come to legislators all over the world with complaints about one thing or any, and you do somehow have to try and learn what is genuine and what is not genuine, and I was perfectly satisfied, as indeed were some 250 of my colleagues, that this is a very genuine and real complaint that they had about this form of taxation, and it was not a superficial complaint. It was very much something that was getting in the way of international trade and causing great problems of aggravation and aggravation in their investment business. So it was very real, the problem.

* * *

[p. 413] Q. (By Mr. Jordan): Now, what did you do, Mr. Grylls, in response to these complaints?

A. We talked with the Government to see what actions the Government could take in an executive way to apply pressure on the United States' administration in Washington to see whether this form of taxation could be changed, and it was that pressure we kept up through many years. Over ten years now.

* * *

[p. 417] Q. (By Mr. Jordan): I don't know where—you were explaining the procedure that is used in Parliament for the acceptance of treaties with other countries. Could you continue with that?

A. Yes. We had a debate which formed the acceptance of this treaty, and during that debate, the Rt. Honorable Peter Rees, R-e-e-s, who was the Minister of the State of the Treasury explained the situation over the clause 9(4) and what happened in the United States Senate, and said that, nevertheless, despite that, the British Government will continue to work in every way it could to ensure that the worldwide combined reporting system of the Unitary taxation would be abolished, and therefore, British companies would be protected.

Now, we took that on trust at that time, and that trust was based not only on the opinion of the Brutish Government, but on assurances from the United States that they too saw it as a serious issue.

Q. You were personally assured that by representatives of the United States?

A. On a number of occasions over the years, yes.

EXCERPTS OF H. BARRY BERLIN

* * *

[p. 493] having been fist duly sworn according to law, upon his oath testified as follows:

DIRECT EXAMINATION

BY MS. IRION:

[p. 564] Q. (By Ms. Irion): Mr. Berlin, what was that determination as to the sufficiency of the information collected centrally for purposes of filing a California worldwide combined report?

* * *

THE WITNESS: There was insufficient information collected centrally for 1977 to file a worldwide combined report for California.

Q. (By Ms. Irion): And just for purposes of clarification, when you did your review in 1984, was there information centrally collected which was sufficient to prepare a California worldwide combined report?

A. In 1984, there also was not sufficient information collected centrally to permit the proper filing of a worldwide combined report for California.

Q. What was the reason for that, Mr. Berlin?

A. The reason that there was insufficient information is because, as I discussed yesterday, the need to make appropriate tax accounting adjustments to financial statement income, and in order to make those adjustments, you [p. 565] have to access to a

detailed level of information and not a summary level of information.

The information that is collected centrally for the Barclays Bank Limited Group did not have a sufficient level of detail to permit an accurate calculation of tax accounting adjustments, and in many cases, alternative calculations where there could be a benefit available to a taxpayer, it was not available at the central location, and would have been— in order to obtain that information, would have required contacting each of the locations where the detailed information resided.

* * *

[p. 578] Q. You were referring to the type of source information which would be necessary to file a worldwide combined report.

Would you need this detailed source information to take advantage of the benefits of the federal and the California tax rules?

A. You would need this information to take advantage of the benefits permitted under the California tax rules which incorporate the federal tax rules.

You don't need them when you file a federal return because a federal return does not require you to accumulate information for business activities of corporations that do not do business in the United States.

Q. So really, it would only be for purposes of obtaining the benefits of the tax rules of California?

A. That's correct.

Q. Except for the purpose of filing a California worldwide combined report, does the Barclays Group have any [p. 579] reason to collect the type of information that you've been referring to?

A. There is no reason to collect the information that I've discussed other than to file a California worldwide combined report.

* * *

VOIR DIRE EXAMINATION

BY MR. MILAM:

[p. 618] Q. (By Mr. Milam): Isn't it true that Price Waterhouse prepared the 1977 California tax return for Barclays Bank International Limited?

A. I believe that's correct.

Q. And isn't it true that that return was prepared on a worldwide basis including—excuse me —

MR. MILAM: May I approach the witness, your Honor?

THE COURT: Of course.

Q. (By Mr. Milam):—including all of Barclays Bank International Limited's international subsidiaries and branches?

A. There was information in the return that indicates it related to that group, but in my view was not [p. 619] information that would have been correct under the California regulations.

Q. That was submitted, though, to the California Franchise Tax Board by Price Waterhouse; was it not?

A. It was.

Q. And it was on a worldwide basis, was it not, including the subsidiaries and Swaziland and all the other Barclays Bank International Limited subsidiaries and branches?

A. It included information relating to Barclays Bank International Limited and its subsidiaries, but no other members of the Barclays Bank Limited Group.

THE COURT: Pardon me. Did I understand the answer? Was it "Included the BBI subsidiaries and branches, but not the BBL"?

THE WITNESS: Right.

THE COURT: The others subsidiaries and branches?

THE WITNESS: That's correct, your Honor.

Q. (By Mr. Milam): I don't want to make another mark on this thing. It would be this, would it not, Mr. Berlin?

A. If I knew where your finger was going to go.

Q. If I were "Plastic man."

THE COURT: Well, for the record, what you've described is the grouping under the heading Barclays Bank International Limited.

MR. MILAM: Yes.

THE COURT: On Exhibit 3.

[p. 620] MR. MILAM: Yes.

THE WITNESS: That's correct.

Q. (By Mr. Milam): Did you ask Price Waterhouse what it cost them to prepare that return for the California Franchise Tax Board?

MS. IRION: Your Honor, this is really getting into the realm of cross-examination.

THE COURT: No, it isn't. Overruled.

THE WITNESS: No.

* * *

[p. 672] Q. In developing this cost, you did not consider the use of reasonable approximations in determining what information was necessary to file a worldwide report; did you?

A. I did not consider reasonable costs. I considered the requirements of the regulations.

Q. Did you mean "reasonable approximations"?

A. Reasonable approximations.

* * *

DIRECT EXAMINATION

BY MRS. IRION:

[p. 694] Q. In your cost study, Mr. Berlin, is there a reason that you did not recommend that the Barclays Group establish a system to collect information which is acceptable only in the discretion of a taxing authority?

A. Yes. Such a system is unworkable from the standpoint of knowing what needs to be provided. If you leave yourself open to a system that's based on facts and circumstances, until you collect those facts and circumstances, you don't know what's reasonable. And in any case, you cannot predict what is going to be acceptable to a taxing jurisdiction.

The approach that has been taken in designing a system is to review what specific information is requested as part of the preparation of the tax return for that jurisdiction and obtain—and design a system that obtains that information.

To try to design a system that obtains three quarters of that information is going to leave you open to an adjustment for tax, open for discussion, and lead to uncertainty in your tax filings. And what you want to try to establish in any tax filing is a high level of certainty that your tax filing is within the requirements of that jurisdiction and is going to be accepted by that jurisdiction as filed.

Q. Is there a reason, Mr. Berlin, that you did not consider the cost for P.W. to prepare a California return in preparing your cost estimate?

A. Yes, there was a reason.

[p. 695] Q. What was that reason, please?

A. First off, P.W. did not provide a—or prepare a worldwide combined report or the Barclays Group.

Second, their—their cost is merely the cost of their efforts in preparing the tax return. What this schedule provides is the cost of all efforts involved in preparing a worldwide combined report.

If P.W. were to come to Barclays and say, "We need a number for worldwide income," what happens is Barclays then, to properly respond, still has to go through this cost internally and come back to Price Waterhouse and say, "We have calculated income according to California rules and regulations," and so the costs—there have been costs incurred at Barclays that P.W. would never show on their bills.

EXCERPT DEPOSITION READ INTO THE RECORD OF JOHN K. SHANK

* * *

[856] "Q. Is it your opinion, Professor Shank, that a taxpayer need not comply with the full letter of the law as stated in the California Revenue and Taxation Code and in the regulations?

A. That is my opinion, yes."

* * *

"Q. Did you understand my question?

A. Yeah. Full letter of the law, I understand what that means, in my opinion.

Q. What does that mean to you?

A. I don't—I don't know how to quite get at it. There is a concept to the tax, okay? The concept of the tax says you earn a certain amount of money worldwide, and California is entitled to tax a proportion of that. And the [p. 857] proportion is based on a weighted aggregate of property—of a property factor, a sales factor and a payroll factor.

Now, full letter of the law involves, you know, a very long circuitous, detailed summary, some set of adjustments, and I don't believe that any corporation in the world— personal, professional opinion—fully qualifies, you know, with any legislation like that."

MS. IRION: I think it's "complies."

* * *

"A. Fully complies, you know, with any legislation like that. It's always a question of materiality, estimates, judgement. How far do we have to go so that we are in substantial compliance? Where that becomes a definition, that's worked out between the taxpayer and the taxing authority."

* * *

[p. 860] "Q. Let's talk about your 25 years of experience. Do you know any other system in the world that requires a subsidiary in order to file its tax return to know the income of the combined unitary group?

A. You're asking me the specifics of the California law?

Q. I'm asking you—

A. No, I don't know of one.

Q. Do you know of any other system in the world, taxing system, which requires a subsidiary of a foreign parent to request information from the parent in order to file its separate return?

A. No.

Q. Do you know of any other system in the world that requires a subsidiary to request information from a foreign parent about property or payroll or sales of other entities [p. 861] in order to file its return?

A. No."

* * *

[p. 862] Q. Do you know—were you informed by Mr. Miller that there was any foreign-based taxpayer that could file its California worldwide combined return under the methodology set forth in the California Revenue and Taxation Code and 25137 regs that you reviewed for foreign-combined operations?

A. Yeah. The answer is no.

[p. 863] Q. Okay.

A. I don't think anybody in the world has an accounting system—certainly not a foreign-based multinational—that would permit them from their existing accounting system to produce a return that was in full technical compliance with the regs."

* * *

"Q. When you say certainly not a foreign-based multinational, why is that?

A. Because for a foreign-based multinational, you get two additional sets of complications which are not there for a U.S.-based multinational.

Q. And what are they?

A. First is the difference in the—in accounting standards. A U.S.-based multinational has all its accounting systems designed to produce financial statements that wind up in accordance with U.S. generally-accepted accounting principles.

A. U.K. based multinational, for example, would have its accounting systems set up to produce financial statements in the end that [p. 864] are in accordance with the U.K. accounting standards, and those are different.

So that a foreign-based multinational has one major set of problems adjusting to U.S.-based—U.S.-based accounting standards, that's one.

Q. And are there significant differences in accounting standards, generally-accepted accounting standards between the United States and other countries?

A. Yes.

Q. And what is the second factor that you base that upon?

A. The second factor is the currency translation. The foreign-based multinational has its accounting system set up to generate financial statements in its home currency. And that is certainly not the U.S. dollar. So for them to comply

with U.S. tax legislation, they have to then create financial statements in U.S. dollars which is another whole big set of problems.

Q. And in your mind, would that factor make it more difficult for a foreign-based company using existing accounting system to attempt to comply with the California statute and legislation?

A. Yes. And going beyond that, it [p. 865] would make it so difficult that I don't believe it would be possible for—I don't believe any foreign-based multinational would have an accounting system that would enable it to produce a tax return in full technical compliance with California law."

* * *

"Q. Are the accounting systems set up for domestic-based multinational corporations sufficient, in your opinion, to comply with the statutes and regulations for filing a combined report?

A. There are still two major problems left. The answer is no because of two major problems that are still left even for the domestic multinational.

One of which—I'm sorry, do you want me to tell you the two?

Q. Yes, please, I would appreciate it.

A. One is the difference between accounting records for management purposes and public reporting purposes versus accounting [p. 866] standards for federal tax purposes. Those are different.

And the second even beyond that are the different tax laws, plural, for individual states versus the federal tax laws. There are differences there."

* * *

[p. 867] "Q. Can Barclays Bank and Barclays Group comply with the procedure set forth in 25137-6 Methodology 1?

A. Okay. The answer—could they, yes. At a reasonable cost, no."

* * *

[p. 868] "Q. Let me ask you the same question. Could Barclays Bank the Barclays Group comply with the methodology set forth in Method 2 of the 25137-6 regulations at a reasonable cost?

A. Using approximations, yes."

* * *

"Q. Excluding the use of reasonable approximations?

A. Yeah. Then the answer is no they could not.

Q. Okay.

A. At a reasonable cost.

Q. At a reasonable cost. And that is even considering the concept of materiality?

[p. 869] A. That is right."

* * *

Would your answer be the same for every other foreign-based multinational company?

A. Yes.

Q. Would your answer also be the same with respect to domestic multinational companies?

A. Yes."

* * *

[p. 870] "Q. Incidentally, if the Franchise Tax Board does not accept the reasonable approximations offered by a taxpayer, what's the penalty to the taxpayer?

A. I have no idea. I mean, essentially the penalty is terribly onerous. That means you have to produce. You have to go well beyond what is reasonable to comply with the return. I don't know what the legislative relief would be.

* * *

EXCERPTS OF BERNARD L. CALDWELL

* * *

[p. 904] having been duly sworn according to law, upon his oath testified as follows:

DIRECT EXAMINATION

BY MR. JORDAN:

[p. 910] Q. These regulations in Exhibit 12 before you [p. 911] require a foreign—that is, a non-U.S. multinational corporation to report income for tax basis on the worldwide unitary method; is that correct?

A. Yes.

Q. Now, in your experience and your understanding of the regulations, do those regulations impose upon a foreign multinational corporation any step or steps not required of domestic multinational corporations?

A. Yes.

Q. And to comply, does the foreign multinational corporation have to compile data which is unnecessary for any other purpose?

A. My opinion, to properly file the unitary return, there are records that will be required to be maintained which are only for the purposes of filing that return.

Q. And does this compilation of extra data constitute a burden to such corporation?

A. It can, yes.

Q. And could you characterize that as heavy or light or —

A. In many instances, it could be rather expensive.

Q. And would an expansion of that opinion of yours depend upon the nature of the corporation, the countries of operations, branches, and that sort of thing?

A. Certainly. To the extent that there are numerous non-U.S. subsidiaries located in more than one [p. 912] country or numerous countries, the greater the number of corporations and the more expansive throughout the world their operations are, the more difficult and expensive it is to accumulate the data necessary to file the return.

* * *

[p. 932] Q. All right. Now, Mr. Caldwell, it's been stated as part of the evidence in this case by an expert for the Franchise Tax Board that—and I quote: "I don't believe any foreign-based multinational would have an accounting system that would enable it to produce a tax return in full compliance with the California law."

Do you—in your experience, have you observed or do you have an opinion that this is a true statement?

THE COURT: Excuse me. From what did you just read?

MR. JORDAN: I read from Exhibit 69, which is the excerpt—

THE COURT: All right.

MR. JORDAN: —of Shank's deposition.

THE WITNESS: I would agree with that statement.

Q. (By Mr. Jordan): Now, in the event that a foreign-based multinational does not have an accounting [p. 933] system that would enable it to comply with the California Revenue and Taxation Code, is there any other method or procedure outlined in the regulations that would help such a taxpayer out?

A. In my practice of taxes, I have not found that there is another method that would help taxpayers.

The regulations do refer to a method which can be requested that would apply some general guidelines to the determination of

what the tax base is, but in my experience, I have not seen that operate either accurately or consistently.

Q. Well, let me be specific and ask you about the portion of the regulations that state that only material adjustments need to be made to comply.

Are you familiar with that section?

A. Yes.

* * *

[p. 934] Q. Well, let me just go right to that then. Is it—can a taxpayer, foreign multinational taxpayer, comply with the regulations relating to the California franchise tax by simply making adjustments to published financial information?

A. I don't believe that that would constitute a proper filing, merely to take the consolidated financial statements and use those for the purposes of filing a franchise tax return.

And I say that based upon my experience with revenue examining agents of the Franchise Tax Board and their requirement that there be an analysis made of specific accounts and substantial adjustment made to that reported income.

Q. Now, by published information, I am referring to such things as reports to shareholders—

A. Reports to shareholders, reports to regulatory authorities.

Q. Such as the SEC?

[p. 935] A. The SEC, or banks, to the Controller of the Currency, or to the FDIC.

Q. Now, would a taxpayer be able to make material—make only material adjustments to its financial data without knowing the entire financial situation of the corporation?

A. That is the point, unless you have accounting information which will permit you to measure the difference between the income or expense reported for financial statement purposes and the amount of income or expense that the Franchise Tax Board regulations require, you never know if it is material, and they would not know if it is material.

Therefore, my opinion is you must have records that will produce how much that difference is. And that then permits you to file a correct return with the Franchise Tax Board.

Q. So putting it another way: If a foreign-based multinational corporation did not have an accounting system in place that would enable it to comply with the California method, it would not be able to tell the Franchise Tax Board which adjustments are material and which adjustments are not material; is that correct?

A. That's correct.

* * *

[p. 936] Q. Just paragraph 1.

A. "In computing the income and any of the factors required for a combined report, the Franchise Tax Board shall consider the effort and expense required to obtain the necessary information.

"In appropriate cases, such as when the necessary data cannot be developed from financial records maintained in the regular course of business, the Franchise [p. 937] Tax Board may accept reasonable approximations."

Q. Now, is this a method, in your opinion, that would allow a foreign-based multinational corporation to comply with the California income tax regulation?

A. I have the same problem as previously discussed when we were talking about going from financial statement income to taxable income. Without a system of accounts or records in order to determine the amount of any particular difference between a detailed reporting and a reporting on some other basis, the facts are not known, and therefore, you would be unable to file on that method.

Q. Now, Mr. Caldwell, is there any provision in this section of the California income tax regulation or any other regulation in the State of California that would enable you as a tax preparer, or give you any guidelines as a tax preparer to help you in determining what are reasonable approximations or what are material adjustments to the financial data?

A. I have been unable to find any definition of what is reasonable approximation or—

Q. In—am I correct to state, then, this would depend upon the whim of the particular auditor that is handling your tax return with the Franchise Tax Board?

A. In practice, the auditors request detailed information with respect to specific items of income or expense or overall methods of accounting for them to judge whether it is material.

Unless you have the records, you are unable to [p. 938] provide the information they request, and therefore, you subject yourself to an unknown tax base, which I believe is unacceptable when you are preparing tax returns for—for clients.

Q. Is this unknown tax base—this would be a liability on the part of the corporation; wouldn't it?

A. Yes.

Q. And is there any way that you as the auditor for the company or the counsel for the company to be able to determine in advance what this tax liability would be to make provision for—

A. No, you cannot determine what the expense would be unless you have the information that would tell you what the difference would be in the taxable income. That requires the records again.

You have no basis of comparison unless you have determined what the differences are in accounting methods or in reporting. Kept records, then, that would permit you to measure what that difference is between the financial statement income or expense and what California's regulations require as the proper recording for their purposes of income or expense.

Q. Now, in subsection 2 of (e)—you have just read subsection 1. But in subsection 2, there is a provision that the taxpayer can request advance determination of the liability from the legal division of the Franchise Tax Board.

Does that help you out in determining what the tax liability of a foreign multinational corporation would be?

[p. 939] A. In my experience, it hasn't.

Q. It has not?

A. It has not. And the reason is that it states that you must file the facts and circumstances that cause you to request this advance determination, and since—if you have not maintained the records, you have no way to calculate the difference. And that is the critical fact.

You do not know—you do not have the information necessary to file the request unless you have maintained the records, and then that causes you to incur that cost because you must have the records in order to produce the filing.

Q. So neither the material adjustment section, nor the reasonable approximation section, nor the advance determination section, contain any guidelines to you as a CPA on behalf of your clients to determine what the Franchise Tax Board liability would be?

A. That is correct. There is no other information contained other than those we have discussed. They are based upon the facts of the specific taxpayer, and the fact in this case has to be the materiality under that section or under a subsequent section where we are talking about facts and circumstances and the costs.

You must have a position for them to measure it and that is the dollars. Without separate accounting records to determine that, you do not have the facts.

Q. So without any rules or guidelines under those three provisions, the system as applied to a foreign-based taxpayer would be an arbitrary one?

[P. 940] A. It is an unknown one.

Q. Does that make it arbitrary?

A. It becomes arbitrary if it's unknown.

* * *

[P. 946] Q. So the total annual cost, in your opinion, to [p. 947] comply with the California Revenue and Taxation Code would be $2 million?

A. That is correct. There would be an initial set-up of systems, investment of approximately 6.4 million.

Thereafter, an annual burden of $2 million. So the first year, you would be looking at $8.4 million, and in subsequent years, two million annually.

Q So the figure you have for $8,400,000 for total compliance costs would be for the first year?

A. Compliance and set-up for the first year would be 8.4 million.

* * *

[p. 955] Q. You did not take a detailed look at the Barclays' accounting system for the purposes of this cost of compliance; did you?

A. No.

* * *

CROSS EXAMINATION

BY MR. MILAM:

[p. 969] Q. Were you ever informed by anybody at Barclays or Barclays' attorneys in this case that BBI, the—a first-tier subsidiary of BBL, had filed on a partial worldwide basis in 1977 with the State of California?

A. Yes.

* * *

[p. 970] Q. Well, you didn't make any effort to determine what it cost Barclays to file that report, did you?

A. I did not.

Q. In developing a cost to comply with California worldwide reporting requirements, wouldn't it be important to know what Barclays' costs in partially fulfilling those requirements had been?

A. It was a partial worldwide combination, not a complete combination, and based upon my questions and the review of the accounts, it was clear that they did not have the information from

separate accounts that would produce all of the adjustments which I believe would be necessary to file an accurate franchise tax return.

Therefore, I did not think that those costs would have that much value to me in making a determination of what would need to be incurred to do it correctly.

* * *

[p. 1027] THE COURT: I just have one question, Mr. Caldwell.

You have addressed yourself to the difficulties of the foreign parent corporation with foreign subsidiaries complying with California's unitary tax scheme for income taxes.

How would you compare the plight of that type corporation with the plight of, let's say, a New York corporation which equally has foreign subsidiaries, an equal number let's say, and does business throughout the world [p. 1028] through owned subsidiaries, wholly-owned, and some partially-owned and which does business in California to some extent, so as to become subject to the unitary tax law.

Would the effect be the same?

THE WITNESS: It would be more difficult for the foreign multinational, and I have two or three reasons for that.

THE COURT: Will you articulate those for me, please?

THE WITNESS: Yes. One reason, as we talked about, the U.S. corporation immediately is on a U.S. generally-accepted accounting basis under U.S. standards. So you have a better beginning point.

Secondly, I said in the analysis that we had on the two charts that there is some information that is required by the U.S. multinational which is not required by the foreign multinational.

One of the specific areas is that the Internal Revenue Service requires U.S. multinationals to provide information in many cases on a U.S. tax concept basis in and summary form for all of the foreign subsidiaries.

So since that is a requirement under the Internal Revenue Code, a U.S. multinational corporation starts with the U.S. taxable income and then merely makes California franchise tax adjustments rather than going back and making all of the adjustments. And there's just an abundant number of adjustments that would be included under IRS rules. It is much easier to go from there to California than it is to go from foreign [p. 1029] GAAP to California.

THE COURT: Well, however, the domestic New York corporation, let's say, still has to deal with the problems attendant upon its totally-foreign subsidiaries and the laws with which they operate in the foreign countries. Aren't those the same—

THE WITNESS: Yes.

THE COURT: —as what would be involved with this foreign-based—

THE WITNESS: Yes.

THE COURT: —multinational?

THE WITNESS: My point would be going from that worldwide income, which is as difficult for the New York corporation that has foreign subsidiaries as it is for a U.K. company with a foreign subsidiary, to the California taxable income base—and because of the generally-accepted accounting required in the U.S. and the fact that there are analyses and schedules prepared on an information basis for the foreign subsidiaries of that U.S. company—your beginning point is much closer to the taxable income that California has than the foreign multinational.

THE COURT: And that is due to the fact that the IRS has requirements that are applicable to a domestic corporation of any state incorporated and headquarters in any state of the United States affecting its foreign subsidiaries business and their—

THE WITNESS: Required information reporting.

* * *

EXCERPTS OF JOHN DEREK TAYLOR-THOMPSON

* * *

[p. 1033] having been first duly sworn according to law, upon his oath testified as follows:

DIRECT EXAMINATION

BY MS. IRION:

[p. 1040] Q. Now, in the United Kingdom treaties which you negotiated or were aware of, did both the treaty partners come to the negotiating table with the understanding that the separate entity arm's-length basis was the method upon which the income of multinational businesses operating across national boundaries was to be divided?

A. Yes.

Q. Now, was this true for both developed countries and developing countries?

A. Yes.

Q. At this time, the United Kingdom had treaties with developing countries?

A. Yes.

* * *

[p. 1041] Q. In the United Kingdom treaties which you negotiated or were aware of, was there any other basis upon which the income of multinational businesses operating across national boundaries was divided between the U.K. and its treaty partners?

A. No, I'm not aware of any other method than the one I've described.

Q. And this was true even as early as the late 1950s and early 1960s?

A. Yes.

* * *

[p. 1060] Q. And what is the problem with unrelieved double taxation, Mr. Taylor Thompson?

A. Well, the problem there is that the same profits or same income is taxed in two countries, but credit is not fully available for the tax charged in one country against the tax charged in the other.

Q. In your meetings, did you perceive a consensus by the various countries that double taxation was an impediment to international trade?

A. Yes.

Q. Did you also perceive a consensus among the nations that there was an attempt to discourage overseas investment?

A. Certainly not to discourage overseas investment. I think the important thrust was that tax should not be any obstacle to overseas investment, to the free flow of income between countries. The policies of different countries might differ as to whether overseas investment was to be specifically encouraged through the tax system, but the essential point, I think, in OECD was to insure that it did not act as a discouragement.

Q. Double tax would act as such a discouragement; is that correct?

A. It would.

* * *

[p. 1066] Q. Now, in January of 1984, Mr. Taylor Thompson, you assumed the chair of the OECD Fiscal Affairs Committee.

In the January meeting of the OECD Fiscal Affairs Committee, was the issue of worldwide combined reporting by certain states of the United States discussed?

A. Yes, it was.

Q. And what occurred?

A. As I recall, as members of the Fiscal Affairs Committee, we were concerned about the Working Group which had been set up in the United States, and there was discussion at the Fiscal Affairs Committee of the appropriate way of making views of

member countries and of the OECD itself known to the Working Group.

There was also some general discussion about the implications of the worldwide combined reporting method and the fact that it was, of course, contrary to the provisions of Article 7 and Article 9 of the model treaty.

Q. Was there concern about possible spread of the use of worldwide combined reporting at that meeting?

A. Yes, I think so. It's difficult to remember after so long just what was said at a particular meeting, and of course, perhaps I should stress that the details of what were said at the meetings are confidential, but I can certainly say that there was discussion, if not at that meeting, then at another meeting of the Fiscal Affairs Committee of the possible spread of worldwide combined [p. 1067] reporting to other countries.

Q. Was this perceived as problematic?

A. Yes.

Q. And what was the reason?

A. Well, there was concern that if worldwide combined reporting was spread to other countries, it might have a serious effect on international trade for the same sort of reasons as worldwide combined reporting was seen as having a serious affect on trade with the United States, and in California, in particular.

In the statement that you've already referred to as Exhibit 30-A, there was concern about the compliance costs of the method. There was concern about the possibility of unrelieved double taxation which would result from it, and their general concerns about its effects on international trade and advancement.

Q. Was there also concern that adoption or spread of the worldwide combined reporting methodology would cause a breakdown in the system of international cooperation which had been attempted to be developed by the OECD?

MR. MILAM: Objection, asking for an opinion.

THE COURT: The question is: Was there concern, presumably expressed at the meetings, and that's objective, not opinion. I'll overrule the objection.

THE WITNESS: Yes, as I recall, concern was expressed.

* * *

[p. 1069] Q. In August of 1984, did you participate in a British delegation to the State of California expressing concern about California's use of worldwide combined reporting?

A. Yes.

* * *

[p. 1070] Q. Mr. Taylor Thompson, is this the first time, to your knowledge, that Her Majesty's Government—a representative of Her Majesty's Government has gone directly to the states to discuss international problems which have arisen as a result of the state taxation system?

A. Yes. To the best of my knowledge, it had not happened before.

Q. Mr. Taylor Thompson, did representatives of the United Kingdom visit other states of the United States to discuss problems associated with the states of the United States using worldwide combined reporting?

A. Yes.

Q. To which states were those?

A. I recall Florida in particular. I was not myself involved in any of the visits to the other states, so I can't speak with authority about this, but I recall there were—there was a visit to Florida.

* * *

[p. 1073] Q. How much time did the OECD Fiscal Affairs Committee meeting spend on issues regarding the states' use of worldwide combined reporting?

A. Well, it has been on the agenda of each meeting of the Fiscal Affairs Committees that I have chaired, so going back to

January of 1984, twice a year since then, we have had a discussion of the issue in the light of developments.

The United States' delegate has reported on development, and he's been questioned about them, and there has been general discussion which, as you have already indicated, in some cases led to notes being sent from member countries and from the OECD itself.

So it was on the agenda on each occasion and on some occasions took up quite a bit of time of the committee.

* * *

[p. 1074] Q. And was there a reason that the worldwide combined reporting issue was placed repeatedly on the agenda?

A. Because it was a matter of concern to all member countries and because, as we saw it, it did affect international trade and investment, and it was, therefore, very proper that as an international tax matter it should be discussed by the committee.

* * *

[p. 1077] Q. In July of 1985, the United Kingdom Parliament passed retaliatory legislation.

Was this noted in the OECD Fiscal Affairs Committee meetings?

A. Yes.

Q. Did you learn that any other member countries were considering similar legislation at that time?

A. No.

Q. Were other—did other member countries discuss the possibility of enacting retaliatory legislation?

A. There was certainly some discussions of appropriate reactions, and different countries took different views on what would prove to be most appropriate for them.

But as I'm saying, it was only in the United Kingdom that action was taken to legislate in this way. That was duly noted by

the Fiscal Affairs Committee and accepted as a reasonable response for the United Kingdom.

* * *

[p. 1084] Q. Shifting back to the reservation that the United States has made both to the OECD Model Treaty and the United Nations Model Treaty, what is the effect of such a reservation?

A. The effect of such a reservation is that it's seen as an indication of the line the United States and the other countries mentioned will adopt in negotiating treaties. It doesn't in any sense bind them. It's just an indication that they do have a reservation on this part of the model treaty, and, therefore, it's to be expected when they negotiate bilateral treaties, they will have regard to that reservation in the way they do it.

* * *

EXCERPTS OF DAVID R. TILLINGHAST

* * *

[p. 1111] having been first duly sworn according to law, upon his oath testified as follows:

DIRECT EXAMINATION

BY MR. JORDAN:

[p. 1116] Q. Now, I take it, then, that you are familiar with the standards of the world regarding taxing jurisdiction for foreign multinational corporations?

A. Yes, I am.

Q. And can you briefly just give us what that jurisdiction is based on?

A. Well, in the most generalized way, I think the ideas are three. The first is that countries assert the right to tax the income of persons or legal entities based on the fact that those persons or entities are resident or domiciled in the jurisdiction, and thus, for example, the United States would tax the income of a corporation

incorporated in the United States wherever that income would arise.

And that practice is, with variations, followed through the world.

The second basis of taxation is what we call the source basis of taxation, and that arises because it is customary and accepted throughout the world that nations will tax income that arises from activities carried on or property located within its borders, even if that income is derived by a person who is foreign in the sense that that person or entity is not domiciled or resident of the jurisdiction.

And I think the third general—

[p. 1117] Q. Excuse me. Does this refer to—or this method or this piece of jurisdiction referred to as "permanent establishment"?

A. Well, yes. The basis of assertion of jurisdiction—may I rephrase that?

The assertion of jurisdiction based on source is usually predicated on the taxpayer being engaged in some kind of business activity in the jurisdiction, and that means that there must be some activity or presence in the jurisdiction before the source jurisdiction to tax will be asserted.

As a general rule, although there are exceptions clustering around the general rule, this level of—I'm sorry, the level of activity which is required to be carried on in a country before that country will tax has to be a fairly consistent and ongoing conduct of business, and there is a concept which has been built up through the treaty system which says that a source tax will be imposed on this basis only if the activity is carried on in the jurisdiction through something called a permanent establishment, which a laymen would refer to, I think, as a branch.

Now, as a footnote, there are some types of income that are customarily taxed at source without regard to a permanent establishment, and that would be represented by the practice of nations

following of imposing withholding tax on interest dividends or royalties that are sourced in the jurisdiction.

* * *

[p. 1124] Q. Now, as far as the standard of the world concerning taxing jurisdiction, we have discussed, first of all, the nationality or residence of the taxpayer.

A. Yes.

Q. The source of income, and what is the third basis for jurisdiction?

A. Well, I think that those are the two primary bases for jurisdiction. I think that the third principle which applies is that in the exercise of jurisdiction based on source or jurisdiction based on domicile, each legal entity is considered a separate taxpayer to whom jurisdiction is separately applied.

There is—the result of that would be, for example, that if a corporation which is resident in country "A" operates in country "B" through a subsidiary, but not otherwise, the subsidiary would be considered subject to [p. 1125] jurisdiction to tax in country "B" on the basis of its residence or domicile, but corporation "A", its parent, would not be subject to jurisdiction to tax in country "B".

* * *

Q. Okay, let me just interrupt you there.

Can we start with the approach or the concept of separate entity?

A. Um-hum

Q. Could you specifically describe that for the Court as to how that works in international taxation—

A. Well —

Q. — as a standard of international taxation?

A. I think it works at two levels. The first level involves related legal entities to which I referred to the example I gave before.

And it proceeds on the basis that if a legal entity is subject to the jurisdiction of a country to tax, that does not imply that a related entity is subject to that jurisdiction.

The second application relates to the taxation of a permanent establishment or branch that is located in a country. And the general standard of taxation is that in the [p. 1126] case in which a company which is a resident or domiciled in one country has a permanent establishment or branch in the other country, the amount of income of that branch which is subject to tax in that other country is determined as nearly as possible on the basis that that branch is—it is a separate entity and its income subject to tax is determined as nearly as possible as if it were in fact a separate entity.

* * *

[p. 1128] Q. Now, is there any country in the world that is [p. 1129] not in accord—or does not operate its taxing power on multinational corporations that is not in accord with the separate entity method?

A. There is not.

Q. And I may have asked—I—or I do ask you: Is this the custom of nations in regard to international taxation?

A. Yes.

* * *

[p. 1131] Q. Now, just to go back to how this standard came to be, can you testify of your own knowledge where this concept evolved or how it evolved? How long has it been in existence?

A. Well, I ought to divide that into two parts because from personal experience, I can only testify to events that have occurred since 1957. I regret it's been that long, but not longer—but I do think —

Q. Well, you can rely on your studies and—

A. Yes, I can. I think I can comment on what had preceded that since I have spent a considerable amount of time studying that, and I think the answer to that is that [p. 1132] efforts began

to be made as early as 1922 in the League of Nations to see if a basis could be derived for harmonizing those aspects of international tax rules which were not already harmonized.

And the League of Nations appointed a committee of experts in that year which eventually delivered a report and deliberations went on, and then there was a further round—if that's the correct word to use—in 1932 and 1933 is my recollection, in which there was a convening of a committee of experts by the League of Nations and the committee deliberated and presented a report in which it recommended that the nations of the world proceed to deal with international tax jurisdictional matters on the basis of the separate accounting standard. And to a certain extent, to a large extent, that reflected the domestic law of the nations of the world at that time. Certainly, major nations of the world already embodied that in their law, and commencing really from the early '30s, there was a building of consensus, if you will, on that basis through the expanding conclusion of bilateral tax conventions or treaties among the major trading nations of the world.

Q. Is there any distinction between developed and developing countries, to your knowledge, as far as the acceptance of this standard?

A. No, to my knowledge, there is not.

* * *

[p. 1140] Q. Now, what is the expression in international commerce of "harmonization of tax treaties" or tax—

A. Well, the concept of harmonization of tax rules is a concept that trade and investment and flow of services will be freer and more rationally allocated to the extent that the tax rules of the various nations among which these flows occur are the same or at least very closely similar.

Harmonization refers to an effort to try to take disparate tax rules and make them as much as possible the same to avoid double taxation or arbitrary taxation or the kinds of things we talked about before.

Q. And would that goal be including avoidance of whipsawing between various nations as to tax dollars?

A. Yes, it is, certainly. I think there are sort of two sides to the coin, and that is, if there is lack of harmonization, one possibility is that the taxpayer or the enterprise bears the burden of that by being taxed more than once or at excessive rates.

Obviously, there is another side of the coin: If the rules are not harmonious, it is possible that gaps can occur into which income may fall and taxpayers use that kind of disharmony to—we call it whipsawing because you play off one rule against the others, which are not symmetrical, [p. 1141] and there was—there is an excluded middle.

* * *

Q. Now, I take it that in addition to the United States trying to harmonize tax arrangements, this has been the goal of all governments in the world to avoid double tax and standardize their taxation?

A. I think it is a goal which is shared by all the major Free World nations—

The only reason I'm carping is I'm not sure that the Socialist nations have always had exactly the same goals.

Q. Could you characterize this effort as—

A. It's been an ongoing—I would say that it's an ongoing, continuous and—effort which is given prime importance by the people and the nations who are participating in it.

* * *

[p. 1172] Q. Now, you also testified that the custom of nations asserts these two kinds of jurisdiction by regarding each legal entity as a separate taxpayer. Does this mean that the host country would ordinarily have no right to tax another corporation unless the income of that corporation arose in the host country or that corporation was a domiciliary of the host country?

A. Yes, that is correct.

Q. What is the custom with regard to branch income?

A. The, I think, generally accepted rules are that if a company located in another country establishes a branch in the host country, the host country may tax the income which arises from the activities of the branch and that income is generally determined as nearly as possible on the basis that it would be determined if that branch were a separate legal entity.

Q. Do you know of any nation in the world that asserts jurisdiction to tax a branch on a different basis?

A. No, I do not.

* * *

[p. 1176] Q. But in no case, however, will that country take into account income of a related corporation that is neither a domiciliary, nor has its source in that country?

A. That's correct.

* * *

[p. 1214] Q. Now, is there any international tribunal or forum to resolve international disputes over the apportioned formula—the worldwide apportionment formula or tax issue?

A. Not to my knowledge, no.

Q. Does this create problems?

A. Well, it creates problems in the sense that someone who has suffered double taxation as a result of the application of the worldwide combined reporting method has no [p. 1215] recourse.

Q. Now, you testified earlier that administrative double tax can arise under separate entity arm's-length method.

Can this administrative double tax arise under worldwide combined reporting?

A. Well, certainly, not at the moment because there is no one else who employs the method, so there would be no administrative double taxation.

If there were two systems in the world that employ the same method, then the same problems would arise only in a different name. We would be having administrative double taxation be-

cause of inconsistent application of the apportionment formulas, or something like that.

Q. Is there a difference in degree or implication from the type of double tax which arises because of the clash of systems such as worldwide combined reporting and separate and arm's-length imposed—let me start all over.

Is there a difference in degree or implication from the type of double tax which arises because of the clash of systems such as worldwide combined reporting and separate entity accounting as opposed to that arising because of administrative decision?

A. The answer is yes. I mean, if everybody who is concerned with the problem is attempting to apply a separate accounting standard, there may be differences in rules which may create a double tax problem. There may be differences in [p. 1216] administrative determinations that will create a problem.

But everyone, after all, is trying to do the same thing. And therefore, while there were problems, they are fairly—they are not minor problems, but they are limited in scope.

With a comparison between a separate accounting method and a worldwide combined reporting method, the problem is that no one is doing the same thing. They are doing something entirely different, and therefore, it's—you know, it's just not—it's not even trying to do the same thing.

* * *

Q. Well, does the double taxation have any implication for government in addition to the ones you've cited as well as for the taxpayer?

A. Oh, it certainly does. I want to make that clear. If I didn't, I apologize.

If a country has a company that derives income sourced in another country and that other country imposes a tax on a base which is duplicative of the base that the—that the residence country maintains, either the taxpayer is [p. 1217] going to suffer or that government is, and I don't know which one until I know the amounts of the tax, because it is possible for a source country

to impose a tax at a low rate but at a—on a high base of income and come to a tax that may, through accident, be actually fully creditable.

In that case, the taxpayer has not suffered an increase in its tax level, although there has been a duplication of tax. The sufferer of the onus of that is the Treasury of the residence country, which has given a credit for a tax imposed at a low rate on a segment of income that it treats as being rightfully its own, and therefore, it has the right to the tax.

So, the impact doesn't always fall on the taxpayer. It falls on the revenues of the residence country as well in some cases.

* * *

[p. 1222] Q. What establishes the international standard from your point of view?

A. The fact that the same general rules are applied throughout the world by all the nations in their domestic legislation, in the income tax treaties to which they have become parties, and in the model conventions which have been prepared by the organizations of which they are members.

* * *

CROSS EXAMINATION

BY MR. MILAM:

[p. 1249] Mr. Milam: Yes. A paper entitled "Thirty-first Annual Conference, Canadian Tax Foundation, An American View of International Intercompany Pricing Problems" by David R. Tillinghast.

(Whereupon Defendant's Exhibit D was marked for identification.)

Q. (By Mr. Milam): Did you make that presentation?

A. I did make such a presentation. I'd have to read it to be sure, but this looks like the piece.

[p. 1250] Q. Would you turn to page 15?

A. Yes.

Q. And would you read the second full paragraph?

A. You want me to read the part that says "In such a case, the plain fact, which of course must never be mentioned, is that there is no such thing as an arm's-length price. There is no comparable uncontrolled price, and often, there is no very reasonable way to apply the resale price method or the cost plus method."

Q. Yes. And would you continue with the rest of that?

A. Oh, continue. "Thus, under the rubric of 'other,' it is necessary for the Internal Revenue Service and the affected companies to work out ad hoc solutions.

"Sometimes this works well, but sometimes it leads to disputes of particular bitterness engendered largely by the lack of clear principle."

Q. Now, this fourth method that you have said was in the regulations and you have described in your talk to the Canadian Tax Foundation, by its very nature, you cannot establish international standard, can you?

A. I don't understand that question. If I understand, what is going on here —

MR. JORDAN: Let him rephrase it, Mr. Tillinghast.

THE WITNESS: All right.

Q. (By Mr. Milam): The fourth method that you have described as in the regulation and in your speech to the—or talk to the Canadian Tax Foundation, by its very [p. 1251] nature is not precisely used by other countries, is it?

A. Well, the problem—I now see the problem I have with the question. Let me back up.

What we are talking about here is determining the separate income of two legal entities or the branch and the home office which are related, and the objective of the exercise in the United States, as elsewhere, is to determine that income as nearly as may be as if each of those entities had operated separately and dealt in the same manner that it would have dealt with—had dealt with unrelated parties.

That's the object of the exercise. Now, what the comment that you quoted related to and what the question relating to "other" methods relates to is the fact that, particularly in vertically integrated enterprises, there are transactions which involve transfer prices for the passage of goods or services between related parties for which there is no comparable transaction between unrelated parties, and therefore, in that sense, there is no arm's-length price.

Now, under those circumstances, the tax authority has to make a determination of what is the most reasonable way which will conform as closely as may be, anyhow, to a separate accounting standard to determine what would be a correct price.

And there are various ways in which this can be done under the rubric of "other" an what is done under "other" depends upon a judgement of the tax administrator at the time as to what is the most reasonable way to come to the closest possible approximation of separate accounting income.

[p. 1252] Now, "other" is, therefore, not a method. It is a way of trying to cope with adjusting prices in cases where there is no specific method that is applicable, and therefore, some method must be used.

Now, I am sure—although I can't swear to it—that there are many cases in which the way in which an Internal Revenue Service agent responds to that situation is very much the same in which an agent in another country responds to it, and there may be cases in which it is different. I just can't tell you.

Q. Where—there is no exact symmetrical application from country to country of transfer pricing method, is there?

A. Not necessarily, that's right.

* * *

[p. 1259] Q. (By Mr. Milam): Doesn't Article 7 of the OECD convention authorize formula apportionment?

A. In the case of determining the income of the permanent establishment located in one country of a legal entity which is resident in another, under limited circumstances, it does contemplate a form of formula apportionment, yes.

Q. Does the worldwide combined reporting that California uses also utilize a form of formula apportionment?

A. What the California method does—you may characterize it, if you wish, as formula apportionment, but what it does is something entirely different. It takes income of multiple legal entities and it then apportions it to the state according to a percentage derived by formula factors. As you know, that's an entirely different process [p. 1260] from what is done in the case of determining the income of a branch under the OECD treaty—your Honor, I'm sorry, it's under the convention.

* * *

[p. 1269] Q. Isn't it correct that under what you refer to in your Canadian talk as a rubric of "other" in the regulations, isn't it true that many times formula apportionment is used to determine the approximate separate accounting income?

A. Well, we are back to the old shibboleth of what's formula apportionment.

In my experience, I can only tell you that in cases in which a price is being determined under "other," the most usual way or kinds of way in which the IRS seeks to do that is by examining transactions that have passed from—between [p. 1270] related parties, and attempting to divide, if that is the correct term, the profit which was derived by the sale of the ultimate goods to an unrelated person between the two entities, or if there are more than two entities, the entities that participated in that sale.

Now, the basis on which that division of profit is made varies according to the judgement of the auditing agent and the IRS as to what would produce a reasonable approximation of what an arm's-length price would be.

For example, it's not unusual for Internal Revenue Service agents to take the view that a profit on an ultimate sale ought to be divided between a sales subsidiary and a manufacturing parent

in accordance with the relationship of the costs of each of those parties that were incurred in the course of manufacturing and selling the goods involved.

Now, if that is a version of formulary apportionment, then that is formulary apportionment. But I emphasize, in that process, nothing is done to take account of the profits of any entities that may be related to those entities or of any revenue or costs that either of the participating entities may have had which are unrelated to the transactions as to which the price is being established.

* * *

[p. 1277] Q. If Barclays Bank International Limited, which is a United Kingdom corporation which does business in California, received a full tax credit in the United Kingdom for taxes paid to California, there would be no actual double taxation, would there?

A. In that case, the complainant is the government of the United Kingdom and not the taxpayer.

Obviously, if the taxpayer receives a full credit in the United Kingdom for the amount of tax that has been imposed here, its tax bill has not overall been increased, that's true. The complainant in that case is the United Kingdom who will have—who will consider that it has been deprived of revenue that it should rightfully be entitled to because the California tax may have been imposed on a base that's too large.

* * *

[p. 1308] Q. Disregarding what other nations do, in your opinion, is the unitary business formula apportionment method employed by California a proper and fair method of taxation?

A. I don't know how to answer that question. The only thing that springs to my mind, Mr. Milam, is something that I understand has been used by a prior witness, so I embark on the statement with trepidation, but it's the only one that springs to mind. I don't have any inherent reason to believe that it's better to drive on the left-hand side or the right-hand side of the road, but I think everyone ought to drive on the same side.

EXCERPTS OF STEPHEN WETZEL

* * *

[p. 1421] having been duly sworn according to law, upon his oath testified as follows:

DIRECT EXAMINATION

BY MR. NIELSEN:

[p. 1543] THE COURT: I'm going to handle it this way: I'm going to ask the witness a question too.

Is it customary, Mr. Wetzel, when the Franchise Tax Board is confronted with a protest to negotiate and, if [p. 1544] deemed appropriate by the Board as a result of those negotiations, adjust the amount of the assessment?

THE WITNESS: Yes.

THE COURT: And does the Board have a custom and practice of using and taking into account certain factors and certain circumstances in making those adjustments where they are made in such a way as to be favorable to the taxpayer?

THE WITNESS: Yes.

THE COURT: And were those type—were those factors, those same factors that are customarily used with all taxpayers, not just banks, but with all taxpayer entities, were those same factors the ones used here or was there any different—was this taxpayer treated any differently.

THE WITNESS: No. No, it was not treated differently. Of course, each taxpayer—

THE COURT: I understand.

THE WITNESS: —is different to some degree or another in the context of that differness (phonetic). The treatment is the same, yes.

THE COURT: It is more of a uniform practice of the Board to negotiate and to adjust where it deems appropriate; is that not so?

THE WITNESS: Yes. Certainly.

* * *

[p. 1545] Q. (By Mr. Nielsen): Mr. Wetzel, what were the basic sources of information relied upon by the Franchise Tax Board in this audit?

A. The annual reports for BBI, BARCAL, the prospectus and additional information submitted at the protest proceedings through Joanne Garvey.

* * *

EXCERPTS OF COURT & COUNSEL

* * *

[p. 1548] MS. IRION: Your Honor, that's not relevant. We are not here talking about whether the unitary is good or unitary is bad. We are talking about the issue in the case and whether or not there is an international standard. I fail to see the relevance of how we go into whether or not unitary is a good method or economically-fair method.

THE COURT: No, as I remember from reading the [p. 1549] several Supreme Court cases that ultimately this will be the crux of my decision here, one of the basic requirements for a unitary tax to be—to be constitutional is we have to start with the tax being a fair—a fairly-assessed and a fairly—fairly-allocated tax.

MS. IRION: Your Honor, we are not claiming distortion in this litigation.

THE COURT: And that is not an issue?

MS. IRION: No.

* * *

[p. 1551] THE COURT: No, the point, as I see, is to show that—that—for whatever it is worth to demonstrate that the formula the way the State of California has it created and applies it is not—is not an unfair formula, and to that extent, I guess I've gotten myself tongue-tied here because I think I already said that.

If that is not an issue so far as the Plaintiff is concerned, then there is a lack of relevance.

MS. IRION: It's not, your Honor. We are not arguing that the three-factor formula is an unfair apportionment factor formula, and we are not arguing distortion. They are not issues in this case. And the exhibit and the testimony is absolutely irrelevant and immaterial.

* * *

[p. 1552] MS. IRION: Well, generally, adjustments are proposed by the taxing agency to begin with.

Second of all, if you are talking about the regulations, the regulations talk about adjustments which are material, not a $10 million material difference between the worldwide income. So that is a completely irrelevant inquiry.

If you are talking about reasonable approximations, the regulations themselves say that no reasonable approximations shall be used unless the information is [p. 1553] unavailable, and the fact that you are asking this witness—you are asking him to opine with insufficient foundation without a purpose to state. There is nothing in the record that says we are arguing distortion. There is nothing in the record. And there is no allegation of—the three-factor formula is not even in issue.

* * *

EXCERPTS OF JOHN ERIC BISCHEL

* * *

[p. 1645] having been duly sworn according to law, upon his oath testified as follows:

DIRECT EXAMINATION

BY MR. MILAM:

[p. 1679] Q. Are there differences between nations on what constitutes sources of income?

A. There are probably as many differences between nations on what constitutes sources of income as there are nations in the world, which I think are about a hundred and thirty.

Some of the significant differences—an example might be, for instance, the fact that the United States taxes under certain circumstances imputed interest, whereas Canada won't allow a deduction for it, views it as being a Canadian source income.

So there is substantial differences as between countries of over what is—what ought to be sourced in the country.

[p. 1680] For instance, Latin American countries, their impression of what ought to be taxed is everything that they can get their hands on is domestic sourced.

We look at Argentina, Brazil, Venezuela, those countries in particular have a very broad definition of source taxation, and in any international meeting that I've been at, it's been brought home when the Latin Americans are present. They have a very good concept of—

Q. You mentioned imputed interest. I want to clarify the record what you mean by imputed interest and the the—why that's an example of different sources. It's not clear on the record. I don't think I really understand why there is a difference.

A. Well, that would simply be, really a situation in which the United States has—we have—because of imputed interest rules, certain income has arisen within the United States, and Canada would say, "Well, that may be, but we are not going to allow a deduction for it because as far as we are concerned that wasn't income in the first place."

That would be really a situation of what is and what isn't income, and different souring rules as to even what constitutes income as well as whose income is it.

Q. Is the allocation of income for tax purposes a common problem in international taxation?

A. How much time do we have this afternoon? Do I have enough time to answer that question?

It is a—it's a very serious problem under the separate accounting method, and there are a number of [p. 1681] important reasons. The—probably some of the more basic or principal reasons are the fact that different jurisdictions simply take different positions on what ought to be sourced in those particular jurisdictions.

If nothing else, the very existence of the competent authority procedure in the treaties obviously indicates that there are huge differences in terms of how and what ought to be allocated under the separate accounting methodology between jurisdictions.

And large taxpayers sometimes take a divide-and-conquer approach to that particular problem just between jurisdictions.

So there are significant problems, both from the administrator's point of view—there is—there is an article which is quite a good one entitled—

* * *

[p. 1770] Q. (By Mr. Milam): In your opinion, is the separate accounting method of allocating income the international standard for income allocation?

* * *

[p. 1771] THE WITNESS: Well, when I think of a—of a standard, I think there is something in terms of perhaps weights and measures. Everyone decides that this much is an inch (indicating) or that much is a gallon (indicating), and everyone agrees that that's exactly what it is.

Even—and I suppose in the weights and measures, we've—we certainly have differences. The English have what we call long ton on a metric basis. They call our ton a short ton.

We have a U.S. gallon, and they have imperial [p. 1772] gallon. And certainly there are—

MR. JORDAN: I'll—

THE WITNESS: There are different systems both—

MR. JORDAN: Can we have an answer to the question, your Honor?

THE COURT: He is answering it. He is answering it in the way many experts answer questions. Overruled.

THE WITNESS: To continue, certainly there are—even with regard to weights and measures, there are metric systems versus the English system.

There is a worldwide standard, if you want to denominate it as such—it's not my understanding that it really is a standard in the sense that I just described—called the arm's-length separate accounting standard. But that doesn't mean that all the tax administrators in the world are arm in arm marching in a lockstep singing arm's-length to the hallelujah chorus choir. It just doesn't happen that way.

There are many, many differences in terms of the application of that particular standard. Maybe it is what Professor Surrey said many years ago, and he was one of the greatest proponents of the arm's-length standard—in his terms from Harvard—that he indicated that indeed it was a goal.

In other words, it's something that the people strive for, but there's a great divergence in terms of the application of it.

Q. (By Mr. Milam): Is it your opinion that the [p. 1773] separate accounting arm's-length method does not set a standard for the procedures used in allocating income to jurisdictions?

A. No, it does not. The reason being that as a practical matter, there are relatively few jurisdictions that have any substantive description of what they mean by the arm's-length standard, outside of the United States, Canada, Germany, perhaps a bit in France. So really, it's—as Marshall Langer described it, it's really whatever the tax collector says it is going to be.

Q. Who is Marshall Langer?

A. Marshall Langer is a good friend of mine. He's an international tax expert who has done a lot of writing on—particularly on tax treaties. He is probably the most renowned expert in the country in that particular area. He now resides in Neuchatel, Switzerland.

Q. Is it your opinion that the separate accounting arm's-length method is a standard in name only?

A. Yes. Yes. I might add that that's on the basis of—of 20 years experience in the practice in this area as well as being a part of the United Nations Secretariat and sitting through what may seem at the time to be interminable hours of the discussion between tax administrators from developed and developing countries of what—how they ought to really allocate income.

And there are volumes and volumes of pages that I have that I supplied in my deposition. I think I probably put in about ten times as much as any other expert witnesses, [p. 1774] probably about 3,000 pages, which described the proceedings in the United Nations and a number of other articles as well, which simply indicate that there has been a lot of difference and remains a lot of difference over ways—and what is the arm's-length standard, if anything, and how it is to be applied.

It's kind of a joke to be very honest. When we go to international meetings, we stand outside the meeting room and we listen to what's going on inside at the International Fiscal Association congresses, and the vital issues we're talking about, we always look at one another and say, "They are not talking about international income allocation."

And we find that that subject, as a practical matter, is never dealt with on a—really on an adequate basis, and it's not dealt with, for instance, in the treaties. The treaties say nothing about standards for international income allocation. No substantive standards for 50 years.

* * *

EXCERPTS OF COURT AND COUNSEL

* * *

[p. 1815] MR. MILAM: Your Honor, Professor Bischel will testify that worldwide combined reporting method, as applied to foreign parents, does not violate the nondiscrimination clause of U.S. income tax treaties.

* * *

[p. 1821] MR. JORDAN: Well, I also object on the ground of irrelevance as well, which is the Court's suggestion at this point.

THE COURT: Well, if you do that, I'll sustain it. I have not perceived an issue, and your case is closed. You presented your case, and I have not heard any claim asserted, nor have I picked it up in the pleadings, that the nondiscrimination clause plays any role in the claim for the refund here or the claim of constitutionality of the tax as levied.

MR. MILAM: Well, if they'd stipulate, I will withdraw my question.

THE COURT: Well, they really don't have to stipulate. They put on their case. I'm making my ruling that I haven't heard it and it's not an issue.

And they don't say that there is an issue, which is [p. 1822] the equivalent of a stipulation, and that being so, there is no relevancy to this inquiry.

I have, all along, been curious to know and I've been educated and I do know and I'm satisfied to know what the nondiscrimination clause is, but it really doesn't apply in this case.

MR. MILAM: Well, if it does not, then I will move on, your Honor.

THE COURT: I assure you that I'm going to treat it as inapplicable, and unless somebody moves to file an amendment to the complaint and I'm inclined to grant it, which I'm not, or I wouldn't know—

MR. JORDAN: I think it's in the complaint somewhere, but we haven't addressed it.

MR. MILAM: I believe it's in the complaint.

THE COURT: Oh, that's why you pursued it. I see.

MR. JORDAN: There's no evidence

MS. IRION: It's just a matter of law.

THE COURT: I'm sorry?

MS. IRION: Your Honor, we did plead in the complaint a violation of that particular section, except as a matter of law, the argument, we have done nothing except in terms of what the burden in—it's just a question of a matter of law than anything else as far as we are concerned.

THE COURT: I can see now. I read the complaint certainly, but I've forgotten that it was there because ever since I read it, we have been through the Plaintiffs case and there has been no—no pursuit of that inquiry or that [p. 1823] subject, so therefore, I now, with the comments I have from Plaintiffs' counsel, it certainly is a relevant matter.

MR. MILAM: I withdraw my withdrawal of my question. It's—the issue is still in the complaint. I withdraw my question—the question on the record earlier because I thought that they had agreed it wasn't an issue.

Now that it is an issue, I would like to reinstate the question that I had.

THE COURT: Did they state it as an issue?

MR. MILAM: That's what I heard.

THE COURT: I didn't understand them to state that. All they said is that they had pleaded it in the complaint.

MR. MILAM: Yeah.

THE COURT: But they presented no evidence.

MR. MILAM: And they are going to argue in their brief that worldwide combined reporting violates the nondiscrimination clause. That's what I heard. She didn't say it that way.

MR. JORDAN: As a matter of law.

MR. MILAM: Yeah.

MR. JORDAN: But that's a matter of law. It's not a question of evidence.

THE COURT: Well, now can it be divorced from the question of evidence? No. If you are going to argue it as a legal issue in the

case, then I cannot sustain the objection on the ground of relevancy.

MR. JORDAN: At this time, your Honor, it is perfectly clear, the Plaintiffs will withdraw that issue from [p. 1824] this case.

* * *

EXCERPTS OF JOHN K. SHANK

* * *

DIRECT EXAMINATION

BY MR. MILAM:

[p. 1985] having been first duly sworn according to law, upon his oath testified as follows:

[p. 2014] Q. What would it mean to you to be in full technical compliance with these rules? What does the term "full technical compliance" mean to you?

A. I guess what's in my mind is I'm trying to separate out discussions had in deposition and what's already in trial and what I should say now.

When you say the word "full technical compliance," that has sort of two meanings to me. One is if you say full technical compliance, taking the full extent of the regulations which includes what I will call the relief clauses at the end, then that's one definition of full technical compliance.

Now, back it up, another definition that I think could be used called full technical compliance would be to try to be in compliance with that law, if it were not with those regulations—if it were not for the relief clauses, quote-unquote, at the end.

In that sense, I know there is already some of—some of my deposition's entered in as evidence here.

In that second sense, full technical compliance meaning without benefit of the relief clauses, then my opinion is I don't believe

any business could be in full technical compliance with those regs, foreign, domestic or otherwise.

Q. You're a step ahead of me.

A. I wasn't sure what you exactly asked me, I'm sorry.

Q. In your deposition, you define full technical [p. 2015] compliance as your second —

A. Yes, stopping short of that section (e).

Q. Okay. Now, when you say the relief clauses, would you indicate to the Court what you mean?

A. Yeah. The place where I can most readily find them is in this version, which is called "M" and it's section 5(a). I don't know whether—here —

Q. It's Subdivision (e)(1).

A. Under 6, (e)—6, (e).

Q. It's subdivision (e), I believe.

A. Yeah. I'm sorry, I can't find it in that version. If you can—

MR. MILAM: May I approach the witness, your Honor?

THE COURT: Yes.

THE WITNESS: I have it in front of me.

MR. JORDAN: You can even lead him on this part as far as I'm concerned just so the record is clear.

MR. MILAM: Pardon?

MR. JORDAN: You can even lead him.

THE WITNESS: Okay, I now find it. Yes, it's section (e), "Application of regulation," there are, then, two sections of that.

That's the part which I'm calling the relief clauses.

Q. (By Mr. Milam): Okay.

A. Reasonable approximations will suffice.

And my opinion is were it not for the existence of that section, it would not really be possible for a [p. 2016] corporation to be in technical compliance with these regulations because they are very onerous.

Q. Now, (e)(1) deals with the use of reasonable approximations?

A. That's correct.

Q. And (e)(2) deals with advanced determinations from the Franchise Tax Board; is that correct?

A. That's my understanding, yes, sir.

Q. You stated that a corporation could not be in full technical compliance with the regulations as you have defined it in your deposition and without the relief clauses; is that correct?

A. That's correct.

Q. Is that true for a domestic U.S. parent and multinational?

A. I believe it—put it this way: There are additional calculations for the foreign-based multinational, but there is sufficient calculations in here even for the domestic-based multinational, but I still believe technical compliance would be very difficult.

Q. And then would it be difficult for a foreign parent multinational then even to comply with—to be in full technical compliance as you have defined it?

A. I believe it would, sir, yes,

MR. MILAM: Would you read that question and answer back again?

(Record read as requested.)

Q. (By Mr. Milam): Would it be possible for a [p. 2017] foreign parent multinational to be in full technical compliance without the relief provisions, in your opinion?

MR. JORDAN: I'll object to that. All things are possible, your Honor.

THE COURT: I'm sorry. Would it be possible; is that the form of the question?

MR. MILAM: Yes, your Honor.

THE COURT: The objection is overruled.

THE WITNESS: I'll answer in sort of—sort of the spirit of the objection. All things are possible.

Would it be possible? I believe in a cost effective way in my opinion, no, it would not.

Q. (By Mr. Milam): It would not be possible in a cost effective way?

A. Were it not for those relief clauses; that's correct.

Q. Would it be possible in a cost effective way for a U.S. domestic multinational to be in full technical compliance with these regulations, again, without the relief provisions as you have described it?

A. Possible, yes. Possible. In a cost effective sense, probably not.

* * *

[p. 2019] A. On a cost effective basis, in my opinion, no.

Q. And why not?

A. Again, because those provisions require essentially a parallel accounting system. That would not be cost effective just for purposes of compliance with California tax if it were not for the possibility of the relief clauses.

* * *

[p. 2022] Q. (By Mr. Milam): In your work for the World Bank, you've been in, I think, three different countries?

A. That's correct.

Q. In your experience in those three countries, did those corporations maintain records which would set forth their gross receipts?

A. Yes, they did.

Q. How about their historical cost of property?

A. Records that could be used to produce historical cost of properties, yes.

Q. Did that include both tangible and intangible property?

A. Yes, it would.

Q. Would the companies which you dealt with also maintain records which would set forth total rent that it pays?

A. Total rent?

[p. 2023] Q. Rent.

A. That typically would be an item of information available, yes.

Q. And would those—the records that you looked at also include total salaries that those corporations pay?

A. If wages and salaries is total payroll cost, yes, it would typically be available.

MR. MILAM: May I take a short break, your Honor?

THE COURT: All right. We'll take a break.

(Whereupon a brief recess was taken.)

THE COURT: All right. Back on the record.

Q. (By Mr. Milam): I think we finished up before we took a break, Mr. Shank, with your experience in looking at records in other countries.

And I believe you testified that those companies in the other countries set forth their, for example, gross receipts and their accounting methods; is that correct?

A. That would be typically true, yes, in their accounting records.

Q. Those are under the accounting conventions of that particular country?

A. That's correct.

Q. And those accounting conventions may, in fact, differ from U.S. accounting standards; is that correct?

A. They may differ, that's correct.

Q. In the area of gross receipts, for example, what kinds of differences may there be in just your experience in some of these countries between the gross [p. 2024] receipts as indicated on the accounting records in those countries and what it would be under U.S. GAAP?

A. The basic idea is when do you count something as revenue? And there is a range of possibilities as to when you can count something as revenue.

U.S. accounting for manufacturing companies tends to focus on the point of sale.

U.S. accounting for a bank tends to focus on the earning process of the revenue, the passage of time.

In other places in the world, revenue might be recognized closer to the time when the cash is received, for example, rather than when it's earned.

So those are some differences that could lead to a different number for gross receipts depending on the accounting standards being used.

Q. As far as the gross receipts are concerned, from your experience, would the gross receipts under the foreign accounting conventions be reconcilable with that under the U.S. accounting conventions?

A. It's my opinion that they are almost always reconcilable. They maybe different, but they are reconcilable.

Q. And reconciliation means what?

A. Being able to convert from one to the other.

Q. Is that also true for the historical cost of property in your experience?

A. Again, it almost always can be converted from one basis to another.

[p. 2025] Q. And is that the same with the total rents that you mentioned?

A. Yes.

Q. And total salaries also?

A. Yes.

Q. And would it be reconcilable between the two conventions using the information that you had available to you in those countries?

A. That would be true. Yes.

Q. You have testified that the fully—that full technical compliance with the Franchise Tax Board regulations would be very difficult without the relief provisions — difficult, if not impossible, for foreign-based multinationals; is that correct?

A. I believe I said anything is possible if you are willing to pay the cost, but possible in the cost effective sense, without the relief provision, it is my opinion it would not be.

Q. And would your opinion very whether there was a parent corporation with several subsidiaries of whether there was one single corporation that did business worldwide?

* * *

[p. 2026] THE WITNESS: Yeah, in my opinion, the legal form is not a binding constraint.

In other words, this single corporation doing business in multiple locations around the world, of those locations around the world, whether they are branches or divisions or subsidiaries, what the legal form is, they still have the assets in those locations around the world. They still have the revenues in those locations around the world. They still have the payroll in those locations around the world. The problems are exactly the same in terms of compiling aggregate accounting information by one set of standards or another set of standards independent of the legal form.

So whether it's multiple subsidiaries around the world and a foreign corporation or whether it's multiple branches around the world and one corporation has nothing to do with the complexity of the accounting problems. All that affects is equity accounting, if you will. It has nothing to do with asset accounting, revenue accounting, payroll accounting.

* * *

[p. 2029] Q. In your opinion, would it be reasonable for a foreign-based multinational like Barclays to set up a separate accounting system to comply with California tax requirements?

A. Would it be reasonable? Would that involve—would that expenditure be a reasonable expense for them? In my opinion, it would not be a reasonable expenditure for them.

* * *

[p. 2043] Q. And what is your definition of materiality from an accountant's standpoint?

A. I am sorry if this will sound whimsical, but I don't think I can give you a concise, crisp definition of—or any other accountant in the world ever could.

I would come back and simply say: Can you, as an attorney, give me a definition of due process?

You know it when you see it, and you know it when you don't see it.

Materiality to accountants is one of those things like due process to a lawyer. Essentially you know it when it's material and you sort of know it when it's not material, but at the margin, there could be differences of opinion about what is and is not material. And it's extremely difficult to try to write it down or to give it in crisp words, but it certainly does exist.

Q. What function does it play in accounting work?

A. Similar to the function of de minimus non curat lex in the law, I think, so it's—so if it's immaterial, [p. 2044] you don't worry about it.

In other words, you only deal with things that are of sufficiently large magnitude to make a difference in terms of the use to which—to which the information is to be put.

So that's the basic idea. So you don't worry about items that are sufficiently small that they will not change the essential message or the essential uses of the information present.

Q. In your experience—excuse me, strike that.

In your experience in working with tax reporting in your accounting jobs, was there a concept of materiality for tax purposes?

A. In my opinion, there most certainly is.

Q. And how does the concept of materiality for accounting purposes differ, if it does, than the concept for tax purposes?

A. My broad sense of that is tax materiality is a little smaller than financial reporting materiality.

In other words, that in most taxing jurisdictions, the concept of what's immaterial is smaller than the concept of what's immaterial for financial reporting purposes, but there still is certainly a material concept in the tax laws.

* * *

[p. 2045] Q. (By Mr. Milam): In your experience, are determinations of materiality made by accountants without having reference to the precise numbers upon which a comparison can be made?

A. It is my opinion that—that, yes, you very often make materiality judgments without specific reference to the two numbers which are being compared to decide whether the differences of this is material.

* * *

[p. 2058] A. My opinion is that what Mr. Caldwell did for his client in that context is use reasonable approximations. That's the same use of the word approximations that I'm talking about in the context of this litigation.

In my opinion, that's reasonable approximations. Every item—you don't pull them out of the air or make them up.

Every item comes out of the financial records of the company. You're using particular items from the company's books and records just as Mr. Caldwell used specific items. If it turns out that those specific items that the return calls for, you don't have, you use the closest you can—you use what you have that comes the closest that's a reasonable approximation.

So the items that he used when he says there "actual items of income and expense," that's—as far as I'm concerned, that's still using approximations. That's what I mean by reasonable approximations.

So in other words, I believe he did use reasonable approximations even though he chooses not to admit that use of the term.

* * *

[p. 2111] Q. (By Mr. Milam): Professor Shank, in forming the calculation—in determining the figures for the calculation that we went through this morning, how many hours [p. 2112] did you spend in that calculation?

A. I spent approximately ten hours.

Q. And how was that ten hours spent?

A. I spent about one hour making a very rough first-cut calculation, which then I discovered had some serious flaws in it.

I then went back and spent roughly three hours or so with the regs on the key elements, having read the regs before, and having heard reference to them in depositions.

I then spent about three to four hours refining the calculation using the schedules, and the sum of that is roughly ten hours, and that got me to where I was this morning.

* * *

[p. 2113] Q. Have you reviewed the 1977 California return for Barclays Bank International Limited?

A. I cannot recall that I have actually seen the '77 return for BBI. I'm certainly aware of a lot of things about it, but no, I do not believe I have actually seen that tax return. I have seen the BARCAL tax returns for '77. I've heard that return discussed a lot, but I have not actually seen it.

* * *

[p. 2114] THE COURT: 51-P. All right.

MR. MILAM: May I approach the witness?

THE COURT: Sure.

THE WITNESS: Yes. This confirms what I thought I knew would be true about the return.

In other words, the basis on which it's prepared.

Q. (By Mr. Milam): Okay. And would you describe to the court—

A. Yeah, I knew from other information it was prepared on a unitary basis for BBI, and I can tell from this return that it is prepared on a unitary basis for BBI.

I mean, I find apportionment factors shown here, for example. That's what I'm looking at. So that's all I know—I mean, this confirms that it was prepared using the unitary basis.

Q. Do you have an opinion on how many hours should be expended in preparation of such a return?

A. Yes. Yes, two orders of magnitude. I do have an opinion.

My opinion is it should take no more than—it should—it should take no out-of-pocket expense to prepare this because it would be prepared from readily-available information using the same approach that I used for BBL. It [p. 2115] just substitutes a different set of denominators for the factors.

In other words, it comes from information which is available at corporate level. Therefore, involves no incremental expense; only the time of the salaried employees who pull this together. And my estimation is that that should be no more than a weeks' worth of work at most. And that's at most.

Q. And what do you base that opinion on?

A. I base that—first of all, I don't believe that BBI can be in full technical compliance because I agree with Mr. Berlin's testimony that it would take, you know, a very cumbersome system to get there, and Mr. Caldwell's testimony, I agree with that. So I take it from there that they cannot be in actual full technical compliance.

There is nothing different for BBI than for BBL. If they are not in full technical compliance, then how do they get this return? They must have used reasonable approximations. If you are going to use reasonable approximations, how would you do it?

My opinion is they would do it approximately the way I did it. Again, using refinements to that as information is available, or perhaps some other refinements based on differing opinion about what is or is not material.

But essentially, they would do what I did this morning and that should take no more than a maximum of 40 hours of time to do it, and that's probably too much.

MR. MILAM: I would like this marked as Defendant's [p. 2116] Exhibit next in order, your Honor.

THE CLERK: Defense Exhibit RR.

(Whereupon Defendant's Exhibit RR was marked for identification.)

Q. (By Mr. Milam): Exhibit RR is entitled "Return Routing and Control Form."

Would you please review that for a few seconds?

A. Yes.

* * *

[p. 2117] Q. (By Mr. Milam): From your experience as an accountant, can you tell from this form what its function is?

A. I believe I can.

Q. And what is it?

A. I believe it's a summary of the time charges of the firm with regard to a particular tax return.

This is a three-year summary, 1972-1974, and the middle column which I assume is 1973— except they've left the "3" out—by inference. But the middle column is not dated.

This is a standard—quote-unquote standard—I'm sorry, this is a typical kind of a form that would be used in the accounting firm to keep track of the time spent on a particular tax return.

And you see the steps; "I interviewed the client. I prepared the return. I reviewed the return. I did some kind of computer checking." Computax is the computer system.

"If applicable." Typing and proofreading. Apparently it was not typed or proofread. We can—some of it is typed, some of it is not, so they didn't charge for typing and proofreading, and then it's processed.

It's assembled and checked by a reviewer. A manager has reviewed it. It's then signed and dated.

So this is the document showing how much time would be involved in the preparation-review of a particular tax return.

What this one relates to, it does not say which return [p. 2118] it refers to.

Q. What is the taxpayer's name at the tomorrow?

A. Taxpayer's at the top is Barclays Bank International Limited. Or what I've called BBI.

Q. And for 1972, how many hours?

A. Total time for 1972 is 21 hours.

Q. What's the total time for 1973?

A. Assuming that middle column is 1973, the total time is 12 hours.

MR. JORDAN: How can you assume that?

THE WITNESS: I'm assuming it from context, sir. It says, "1972," blank, "1974," that's why I'm assuming.

If it's not 1973—I am not trying to be nonresponsive or argumentative. I don't know what the middle column is if it's not 1973.

Q. (By Mr. Milam): And what's the total time for 1974?

A. For 1974, the column is headed, and it's 19 hours.

THE COURT: Mr. Milam, I have a little confusion. These are '72—I will assume—I will make the same assumption that it's '72, '73 and '74, but does that prove anything with reference to 1977 in terms—do I know, for instance, that there is foundation to show that these '72, '73, '74 returns of BBI were filed under the unitary method? Is that in the record?

MR. MILAM: Yes, I believe Mr. Wetzel testified that they filed on that basis from 1970 through 1981.

[p. 2119] I don't know the exact dates, but Mr. Wetzel did testify that they did it for more than ten years.

THE COURT: I'll accept your representation on that. That being so, the testimony is relevant.

* * *

Q. (By Mr. Milam): I hand you copies of Defendant's Exhibit marked for identification SS and ask you if you would take a few seconds to review those letters, [p. 2120] Professor Shank.

A. Yes, sir, I have done that.

Q. Pardon?

A. I have looked at them.

Q. Referring back to the Defendant's Exhibit RR—

A. Um-hum.

Q. —which is the one I introduced just before these letters, can you tell from these letters what service Price Waterhouse performed for each of these three years?

A. Yes, I can.

Q. Assuming that the middle year in RR is 1973?

A. Yes. These are standard transmittal letters which describe what the accountants did and any particular items they found which they feel is important to point out to the client. I can tell what they did.

The first paragraph said: "In accordance with your instructions, we have prepared and enclose, in duplicate, California franchise tax return for the year ended 9-30-72 for Barclays Bank International Limited showing a tax of" et cetera, et cetera.

"The return has been prepared on the basis of reporting the worldwide income of BBI and allocating a portion of that income to the BBI California agency according to the standard allocation formula for banks."

There is similar terminology for the other two letters.

Q. So for 1972, '73 and '74, Price Waterhouse prepared the California franchise tax return for Barclays [p. 2121] Bank; is that correct?

A. I believe that it is correct, yes, sir.

Q. Did I say "Barclays Bank of California"? If I did—

A. Then I wasn't listening. It's BBI.

Q. For Barclays Bank International Limited; is that correct?

A. (No audible response.)

MR. MILAM: Can we—I have here three pages beginning with a page dated June 15th, 1973 to Barclays Bank International, and I would like to have this marked as Defendant's next exhibit in order.

THE CLERK: Defendant's TT.

(Whereupon Defendant's Exhibit TT was marked for identification.)

Q. (By Mr. Milam): Will you take a few minutes to review these documents, Professor Shank?

A. Yes, I understand what they are now.

Q. Okay. And what are they?

A. These are statements—expense statements or fee statements. It doesn't say who—I'm assuming they go with the Price Waterhouse. That's where they got them.

It doesn't say Price Waterhouse, but it's a statement to Barclays Bank International, "Attention: Mr. Gilbert," the controller. Talking about the fees we've just talked about.

For example, the period of time covered and then the preparation of the California franchise tax return. This one [p. 2122] is for the year ended '72. This one is for the year ended—

Q. And that second one is dated June 18th, 1974?

A. Four. It's for the '73 tax return.

The next one is dated June of '75. It's for the '74 tax return.

Q. And what do those figures read?

A. $1,250 for one year; $900.00 for the second year; $1,100 for the third year.

MR. MILAM: Your Honor, may we have marked as Defendant's Exhibit next in order a two-page document, top page of which is dated June 17th, 1977, and I have one extra copy.

(Whereupon Defendant's Exhibit UU was marked for identification.)

Q. (By Mr. Milam): Would you please review that document?

A. This is similar, bills—statements to Barclays Bank International from Price Waterhouse.

The first one dated June '77 is for preparation of the franchise tax return for the year ended September 30, 1976.

Q. Which—would you read the second page?

A. I'm reading what's on the first one, the June 1977 sheet.

Q. That's the second entry?

A. Yes.

Q. Okay. What about Barclays Bank International Limited return for 1977?

[p. 2123] A. Well, by looking at it, I now see that they did not prepare it for 1977. They reviewed it. It says now, tax and accounting services for that year. "Review of the California franchise tax return for the agency for the year ended September 30, '77." Which means that the client prepared its own tax return for 1977; it was reviewed by Price Waterhouse.

Q. Would you refer to the first sheet of that statement on the first—

A. No, it's not for the year 1977. Price Waterhouse prepared the tax return.

Q. Take a look at the June 17th, 1977—

A. Review of required estimated payments under the '77 tax.

Q. So that's—estimated payments, that's different than preparing—

A. Preparing the return, that's right.

Q. So the second one, then, is the review of the actual return?

A. That's correct.

Q. And what does that tell you?

A. Well, it tells me that in addition to having spent approximately 20 hours a year or approximately a thousand dollars of compensation, Price Waterhouse's involvement with the 1977 return was cut back to a review only, which tells me that the client took on more responsibility for preparing that return.

It's not surprising. I mean, that's the way to save [p. 2124] some money. It's normal business practice for the client to take on more responsibility from the auditing firm if it can do that.

* * *

Q. (By Mr. Milam): Given your experience as an accountant and the work that you have done for this trial, do you have an opinion on whether the amount of time and expense incurred in

these last few exhibits is a reasonable estimate of the time that would be required to prepare a California worldwide combined report using reasonable approximations?

A. Yes, I do have an opinion.

Q. And what is that opinion?

A. Is that it is a reasonable estimate of the cost.

Q. By using reasonable approximations?

A. That's correct. I assume that's the only way to do it, in my opinion.

Q. Professor Shank, assuming that the Barclays Bank International California tax return for 1977 was prepared on a combined basis with Barclays Bank International Limited branches and subsidiaries operating in 55 countries, in your opinion, how much longer should it take to prepare a combined report of the entire group that operates in over 60 countries?

A. In my opinion, it should take trivially longer [p. 2125] amount of time. The only difference is what you put in the denominator of the apportionment factors and which income number you then use to apply that apportionment factor to.

It doesn't matter whether you are doing it for BBI or for BBL. It's essentially the same set of procedures.

Yes, it's somewhat more complicated because it's a bigger entity. How much should that cost in terms of preparing the return? I think—don't think it's anymore than a few more hours. In my opinion, it's certainly not millions of dollars.

Q. According to the California regulations 25137-6, the last step in determining California income is the conversion of the amount of foreign currency denominated income attributable to California into dollars.

In order to complete this step, what would an accountant have to do? Or an employee of an organization who filed a tax return?

A. For that final step, it's my understanding there are two things involved.

One is to take the foreign currency amount of earnings and multiply it by the appropriate conversion rate, which is available from the Wall Street Journal.

The second thing to do is to take that dollar amount of earnings and multiply it by the percentage.

Q. And how long would that take?

A. Well, assuming one had a Wall Street Journal to start with, it takes, I guess, a couple of minutes to look up the exchange rate at that particular date, and then 30 [p. 2126] seconds to multiply that times the percentage. So it's a few minutes, assuming one has the Wall Street Journal.

* * *

[p. 2132] A. All right. Now, you have testified before [p. 2133] today that Exhibit 14, which you have seen and which was the study prepared by Mr. Berlin of the cost of compliance with the California unitary method, do you recall seeing that?

A. This is Mr. Berlin's cost of compliance study?

Q. Right.

A. Yes, I have—I recall seeing that study.

Q. And it's true, is it not, that all the steps that Mr. Berlin has outlined in that exhibit are necessary steps to comply with the California regulations 25137-6 —

A. No, it's not.

Q. I haven't finished my question.—up to section small (e)?

A. Up to section small (e), it is correct.

Q. And everything he outlines in that exhibit, Exhibit 14, is necessary to comply with this particular regulation until you get to small (e), which is entitled—it's entitled "Application of regulation."

A. That is correct.

Well, I don't think everything—I mean, you're not asking me to give—I still think the report is estimates, but that's not what we're talking about.

I mean, do I agree except for that last section? You would have to do something much more onerous and much more expensive.

Whether you have—I agree, yes. Whether you have to do what Mr. Berlin says or not is another question.

Q. Well, let me be precise. Everything that Mr. Berlin outlines in that Exhibit Number 14 has to be done by a [p. 2134] foreign multinational corporation to comply with Section 25137-6 up until section small (e), "Application of Regulations"?

A. Yes. Everything that he says he needs as a result he would need, yes.

Q. And it's also true, is it not, that the corporation trying to comply with the regulation up through small section (e) would have no other reason whatsoever in the world to compile the data that he puts in Exhibit 14 other than to comply with the regulations?

A. If you said up to section (e), up through, not section (e), I agree.

Q. Up to, yes. Right.

A. Yes.

Q. And those—strike that.

And this would be true for every other foreign multinational corporation complying or trying to comply with Section 25137-6, that they would have no other reason to use the information that is compiled by them.

A. That's a very important question, but I certainly can't think of anything other than you can. I don't know what they do with it either other than prepare the California tax return.

* * *

[p. 2172] Q. (By Mr. Jordan): Now, if the Franchise Tax [p. 2173] Board does not accept the reasonable approximations

that you've testified to, do you know what the consequences are as far as the taxpayer is concerned?

A. I'd say if they do not, then it's very onerous. They have to go back to technical compliance—or in your words, full compliance.

Q. Now, this morning, you testified as to the water's edge regulation.

A. I want to say I don't know that—what I'm having trouble is I don't mind giving my opinions about things which I don't think factually —

(Interruption by reporter.)

THE WITNESS: Yes, I believe what I said is I have no problem giving you my opinion as long as you understand that there is a question of fact.

And I may be dead wrong. There may be some super-revenue authority in the State of California that I am totally unaware of.

What I believe is the Franchise Tax Board has the unlimited authority to accept those estimates or not, as it sees fit, and I believe that if the Franchise Tax Board failed to accept those reasonable estimates, that would leave the taxpayer in an extremely uncomfortable position of having to be in full technical compliance or failing to comply with the tax law.

Neither one of those is a very desirable consequence for the taxpayer.

* * *

[p. 2191] Q. (By Mr. Milam): In your opinion, does a foreign-based corporation or any corporation, for that matter, keep information regarding payroll, property and sales only for purposes of complying with California tax law?

A. My opinion is they do not keep such payroll, property and sales information only for purposes of complying with California tax law. They do not.

Q. There are—

A. There are other reasons.

Q. There are other reasons for keeping that information?

A. In whatever form it makes the most sense to them, yes, there would be other reasons for keeping it.

(24)

No. 92-1384

In the Supreme Court
OF THE
United States

OCTOBER TERM, 1993

BARCLAYS BANK PLC,
Petitioner,

VS.

FRANCHISE TAX BOARD,
AN AGENCY OF THE STATE OF CALIFORNIA,
Respondent.

On Writ of Certiorari to the Court of Appeal of the State of California in and for the Third Appellate District

BRIEF FOR PETITIONER

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QUESTIONS PRESENTED

1. Whether California's application of worldwide combined reporting to determine the taxable income of domestic corporations with foreign parents, or foreign corporations with either foreign parents or foreign subsidiaries, is unconstitutional under the foreign Commerce Clause.

2. Whether California's application of worldwide combined reporting to determine the taxable income of domestic corporations with foreign parents, or foreign corporations with either foreign parents or foreign subsidiaries, intrudes into an inherently federal area and is preempted by the United States Constitution.

3. Whether California's application of worldwide combined reporting to determine the taxable income of domestic corporations with foreign parents, or foreign corporations with either foreign parents or foreign subsidiaries, is unconstitutional under the Commerce Clause where such application imposes discriminatory compliance burdens on such entities.

4. Whether California's system for compliance with worldwide combined reporting violates the Due Process Clause of the United States Constitution where compliance is not possible without undue cost and the system, to function, depends on discretionary relief provisions without constitutionally sufficient standards to guide application and prevent arbitrary enforcement.

LIST OF PARTIES

The parties are as stated in the caption. In the courts below, the plaintiffs and respondents were Barclays Bank International Limited ("BBI"), a United Kingdom corporation, and Barclays Bank of California ("Barcal"), a California corporation which was wholly owned by Barclays Bank International Limited. BBI was merged with Barclays Bank PLC and Barcal was sold to Wells Fargo & Company, with the present tax matters and claims for refund being assumed by Barclays Bank PLC.*

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*Pursuant to Rule 29.1 of the Rules of this Court, Petitioner states that during the income year 1977, BBI was a wholly owned subsidiary of Barclays Bank Limited ("BBL"), also a United Kingdom corporation. During income year 1977, Barcal, a domestic corporation, was a wholly owned subsidiary of BBI. On February 15, 1982, BBL reregistered as a public company under the provisions of the Companies Act 1980 of the United Kingdom and changed its name to Barclays Bank PLC. On January 1, 1985, under the terms of the Barclays Bank Act 1984 of the United Kingdom, the United Kingdom banking business of Barclays Bank PLC was merged with the international and other overseas banking operations of BBI under the name Barclays Bank PLC. The ultimate parent of Barclays Bank PLC is now Barclays PLC, listed on the London Stock Exchange. On February 20, 1988, Barclays Bank PLC sold the stock of Barcal to Wells Fargo & Company. Under the terms of the agreement, Barclays Bank PLC assumed any tax liability at issue herein and retained all claims for refund. Barclays Bank PLC's non-wholly owned subsidiaries are listed in Appendix I to this brief.

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On Writ of Certiorari to the Court of Appeal of the State of California in and for the Third Appellate District

BRIEF FOR PETITIONER

OPINIONS BELOW

The Statement of Decision of the California Superior Court (Appendix A to the petition for certiorari)[1] is an unreported decision. The first opinion of the Court of Appeal of the State of

[1]All references to the appendices to the petition for certiorari are denominated "PA" followed by the letter of each appendix and, where necessary, a page reference. References to other materials are as follows: (i) appendices to the petitioner's supplemental briefs are "PSA(1) or (2)" followed by the letter of each appendix; (ii) Joint Appendix references are "JA"; (iii) testimony not reproduced in the Joint Appendix is cited as "R" followed by page number; and (iv) trial exhibits not reproduced in the Joint Appendix are cited as "Ex."

California in and for the Third Appellate District (PA B) was reported at 232 Cal. App. 3d 1187 (1990) and again at 3 Cal. App. 4th 1034 (1990) to permit tracking of the case pending review by the California Supreme Court.[2] The opinion of the Supreme Court of California (PA C) is reported at 2 Cal. 4th 708 (1992). The opinion of the Court of Appeal on remand, as modified, is reported at 10 Cal. App. 4th 1742 (1992) (PA D). The California Supreme Court denied further review on February 18, 1993 without opinion (PA E).

JURISDICTION

The jurisdiction of this Court is invoked pursuant to 28 U.S.C. § 1257(a). The California Supreme Court's May 11, 1992 opinion (PA C) decided the first question presented but remanded the cause to the California Court of Appeal for consideration of the remaining federal issues. The California Court of Appeal issued a judgment upon remand and the California Supreme Court denied a timely filed petition for review on February 18, 1993. Petitioner filed a petition for writ of certiorari on February 22, 1993, which this Court granted on November 1, 1993.

CONSTITUTIONAL AND STATUTORY PROVISIONS INVOLVED

The constitutional, statutory and regulatory provisions involved are: Article I, Section 8, Clause 3 of the United States Constitution (the Commerce Clause); Article VI, Clause 2 of the United States Constitution (the Supremacy Clause); Amendment XIV, Section 1 of the United States Constitution (the Due Process Clause); California Revenue & Taxation Code Sections 25101 and 25137; and California Code of Regulations, Title 18, § 25137-6. The texts of the constitutional and statutory provisions are set forth in PA F. The text of the regulation is reproduced in PA J.

[2]Pursuant to the California Rules of Court, Rule 976(d), the opinion of the Court of Appeal was vacated by the Supreme Court of California's grant of review on February 28, 1991.

STATEMENT

The issues raised by this case — issues specifically reserved by this Court in *Container Corp. of America v. Franchise Tax Board*, 463 U.S. 159 (1983) — concern the powers of a state to tax a domestic corporation with a foreign parent, or a foreign corporation with either a foreign parent or foreign subsidiaries, under worldwide combined reporting. The precise question presented is whether California's application of worldwide combined reporting to Barcal, a domestic corporation with a foreign parent, and to BBI, a foreign corporation with a foreign parent and foreign subsidiaries, is unconstitutional.

California's method of taxation already has caused serious national and international repercussions. The United States appeared as amicus curiae in the courts below to assert that this method is "patently unconstitutional", PA H-25 n.13, and created interference in the United States' conduct of its foreign economic policy.[3]

1. THE BUSINESS OF THE BARCLAYS GROUP.

In 1977 Barcal and BBI, the California taxpayers, were part of the Barclays Group, a United Kingdom banking group of over 220 corporations doing business in some 60 nations. PA A-23. BBI and BBL agreed for purposes of the litigation that they were members of a worldwide unitary business for 1977. JA-16. The ultimate parent, BBL (now Barclays Bank PLC), was one of the United Kingdom clearing banks. JA-10. Only two corporations in the Group (Barcal and Barclays Bank of New York) were incorporated in the United States and only one other corporation in the Group, BBI, also did business in the United States. JA-10. The Barclays Group conducted over ninety-eight percent (98%) of its business outside the United States. PA A-23. The Barclays

[3]The United States appeared as amicus curiae in the California Superior Court, Court of Appeal and Supreme Court (PA H) and in this Court in support of Barclays' first petition for certiorari (PSA(1) K). The United States opposed grant of Barclays' second petition for certiorari. U.S. Am. Br., No. 92-1384. *See* Part 6 of the Statement, *infra*.

Group was and is involved in all phases of international banking, including retail, merchant, and commercial banking, leasing and consumer credit and finance. JA-10 to 11.

BBI was organized under the laws of England and was domiciled and doing business in the United Kingdom. JA-9 to 10. BBI also did business in more than 33 other nations and territories outside the United Kingdom, including the United States. JA-10. BBI operated a banking agency in California. JA-9 to 10. BBI itself owned, directly or indirectly, more than fifty percent (50%) of over 70 subsidiary corporations which also operated in approximately 34 nations and territories outside the United Kingdom. PA A-23; JA-10. Barcal, a California banking corporation, was a wholly owned subsidiary of BBI. JA-11.

2. THE INTERNATIONAL STANDARD FOR DIVISION OF INCOME AMONG NATIONS FOR TAX PURPOSES AS COMPARED TO WORLDWIDE COMBINED REPORTING.

The United States, the United Kingdom and other nations of the world divide the income of multinational enterprises among nations for tax purposes by the arm's length separate accounting method ("the arm's length method"). PA A-20; JA-821, 824. The arm's length method treats each corporation as "an independent entity dealing at arm's length with its affiliated corporations, and subject to taxation only by the jurisdictions in which it operates and only for the income it realizes on its own books." *Container*, 463 U.S. at 185. Where a corporation crosses national boundaries, the host (nondomiciliary) country taxes that corporation only on the profits earned in the host country by that corporation. PA A-20; JA-820 to 21. Profits earned by that corporation in other countries, and profits earned by affiliated corporations in other countries, are not taxed by the host country. PA A-20; JA-824.

The United States has been a leader in establishing the arm's length method as the international standard. R 62 to 64, 1138 to 41. Both the United States and its trading partners use this standard in all bilateral tax treaties and in their internal tax laws. PA A-20; R 212 to 13, 1129 to 31, 1168 to 69; Ex. 37I at 74 to 75.

The standard is "universally used and favored" by the nations of the world both "as an ideal and as a working methodology." PA A-20 to 21; JA-813, 826; Ex. 37C at 33 to 34. The arm's length standard is the custom of nations. PA A-20 to 21; JA-821.

California uses a different and incompatible method to divide the income of a multinational enterprise for tax purposes — worldwide combined reporting (sometimes called the "unitary tax"). PA A-20 to 21; JA-70, 98, 581 to 82; R 65 to 67, 1142, 1146. This method aggregates the income of all entities which form a part of a unitary business, wherever they do business, and determines California's share of this aggregate income by a formula, generally the average of the property, payroll and sales within and without California. PA A-20 to 21. Under this method, the income of all affiliated corporations in the unitary business is included in the California tax base (subject to apportionment), even the income of foreign entities operating solely in foreign countries and doing no business in the United States, let alone in California. PA A-27; *see also* JA-788 to 91. This is true even where most of the corporations in the unitary group are wholly foreign entities. *Id.*

Worldwide combined reporting has as its economic underpinning the assumption that all parts of a multinational business are equally profitable. JA-73; Ex. 37C at 34; Ex. 37I at 77. This assumption fundamentally differs from and is incompatible with the arm's length method which recognizes that costs, values and profits can vary significantly among countries. JA-73 to 74. The income allocated to a tax jurisdiction under the arm's length method can and does differ substantially from the income apportioned to that jurisdiction under worldwide combined reporting. JA-68, 581; Ex. 37D at 3; Ex. 46N. There is no way to reconcile these differences, because the usual means for reconciling disputes (through the reallocation of income from particular transactions) cannot be applied to a system that divides income by formula rather than by transaction. *See* JA-75.

Because the income and factors of all members of the group must be included in the combined report, the California system requires worldwide tax information for all of these companies, not just for those that are California taxpayers. PA A-27. Foreign

multinational enterprises incur greater costs to comply with California's reporting requirements than do domestic multinational enterprises and those domestic enterprises doing business only in the United States. PA A-26 to 27; PA D-9. While domestic enterprises keep most of their records in accord with United States financial and tax accounting principles, foreign enterprises generally have no reason to collect worldwide information in that form except to comply with the California tax system. *Id.* The international standard does not require the reporting of such information. PA A-27. Such foreign enterprises incur significant costs in obtaining the necessary information and transforming it into California tax information. PA A-27 to 28; PA D-9 to 10.

3. THE IMPACT OF CALIFORNIA'S APPLICATION OF WORLDWIDE COMBINED REPORTING TO FOREIGN OWNED MULTINATIONALS.

In the early 1970's, the California Franchise Tax Board first began to apply worldwide combined reporting to foreign owned multinationals. PA A-17. The extension of this conflicting method into the international arena brought immediate complaints from both foreign business and foreign governments. PA A-21; JA-770 to 72, 774; Ex. 37C at 33; Ex. 37I at 78. Foreign governments bombarded the United States government with formal and informal diplomatic protests about worldwide combined reporting as applied to foreign multinationals. Over the years these have included: diplomatic notes from virtually every developed country in the world; protestations directly to the President from heads of nations including Prime Minister Thatcher of the United Kingdom, Prime Minister Nakasone of Japan, and Prime Minister Trudeau of Canada; delay in treaty negotiations by the Netherlands and West Germany; and strong representations from the French, Danish, Italian and German governments. JA-92 to 123, 132 to 140, 600 to 03, 753, 771 to 74, 782; Exs. 32 D, E, F, H, K, N, O; Exs. 32 HH, II, JJ. The Canadian and French tax treaty negotiators insisted on an exchange of notes which called attention to their concerns and which obligated the United States to reopen discussions with each country if an acceptable solution could be devised. JA-477 to 83.

Foreign governments even attempted unprecedented direct persuasion at the state level. JA-779 to 80, 816.

The United States State Department acknowledged that few issues have provoked so broad and intense a reaction from foreign nations. JA-576. The State Department summarized the foreign nations' principal criticisms of worldwide combined reporting and characterized those criticisms as "sound":

- The unitary tax method imposes an onerous administrative burden, particularly for foreign-based multinationals. Foreign-based companies do not keep worldwide records in dollars, in English, or in accordance with U.S. accounting standards, but states imposing the worldwide method require reporting on those terms.

- The unitary tax method leads inevitably to extra-territorial and double taxation. The unitary method assumes uniform returns throughout the world, but international investment occurs precisely because such returns differ. Greater risk is reflected in relatively high rates of return as a compensation. The worldwide unitary method allows a state to reach beyond its borders and tax higher profits earned elsewhere.

- The unitary tax method is contrary to international practice. The League of Nations rejected formulary apportionment (unitary tax) many years ago. The United States and the other OECD members have actively supported adoption of separate accounting, with arms length adjustment, as the international standard, a method that more nearly corresponds with the way business is actually conducted.

- Use of the unitary tax method by states of the United States encourages the developing countries to adopt the same method.

- The unitary tax method discourages investment in those states that apply unitary taxation and in the United States generally since any state may adopt the method.

JA-575 to 79. *See also* JA 68 to 79, 113 to 17, 774 to 78.

In 1985, after years of diplomatic effort, the United Kingdom enacted retaliatory legislation which would deny certain treaty benefits to United States corporations operating in unitary states. JA-127 to 28, 141 to 48. The legislation had a chilling effect on the willingness of United Kingdom subsidiaries of such corporations to repatriate dividends. JA-603.

4. THE POSITION OF THE UNITED STATES.

The Federal Executive has steadfastly promoted and adhered to the use of arm's length separate accounting for the division of international income, has opposed the application of worldwide combined reporting to foreign multinational enterprises through all Administrations, both Democratic and Republican, confronted with this issue, and has consistently taken the position that such application is unconstitutional.

Initially in response to, and after study confirming, complaints from foreign governments on increased risk of double tax, administrative burden and possible retaliation, the United States added Article 9(4) to the tax treaty then being negotiated with the United Kingdom. PA A-18; JA-783. Article 9(4) would have required states to use the arm's length method when taxing affiliates of United Kingdom companies. *Id.* A reservation which would remove Article 9(4) from the Treaty was defeated in both the Senate Foreign Relations Committee and the full Senate. PA A-18; JA-243, 390-92. The Senate voted 49-32 (5 votes short of the necessary two-thirds) to ratify the Treaty including Article 9(4). PA A-18; JA-392 to 94. The Treaty was resurrected after parliamentary maneuvering in which the reservation was added without a separate vote, and the Treaty, with the reservation, was ratified by the Senate. PA A-18; JA-408 to 10. The reservation was subsequently included in the Third Protocol to the Treaty, which also contained other changes. Ex. 37B. The United Kingdom ratified the Treaty only after strong assurances from the United States that the matter of worldwide combined reporting would be resolved. PA A-18; JA-71, 793 to 94.

All Presidential Administrations since President Nixon have been faced with the issue and continued with efforts at solution. JA-771 to 74. In 1985, after passage of the United Kingdom

retaliatory legislation, President Reagan instructed the Secretary of Treasury to pursue a resolution to the problem through federal legislation and treaty negotiation, and instructed the Attorney General to ensure that the United States interests were represented in appropriate litigation. JA-191 to 92. The appearance of the United States as amicus curiae in support of Barclays in all three California courts, beginning with the trial court, and in this Court in support of Barclays' first petition for certiorari, was a part of such efforts.

Congress has enacted no legislation dealing with this issue. R 228 to 29. Ex. 37C at 89. Bills concerning unitary taxation have been introduced, but there has never been a vote in a congressional committee or in either house of Congress on such a bill. *See* PA A-31 to 32. None of the bills has dealt solely with worldwide combined reporting as applied to foreign multinational enterprises. *Id.*

5. CALIFORNIA LEGISLATION.

In 1986 California enacted legislation which allowed multinational businesses to elect out of the use of worldwide combined reporting in favor of a "water's edge" method which limited the entities to be combined for a California return. JA-696 to 745. The United Kingdom welcomed the passage of that legislation as a "major step toward complete withdrawal" of worldwide combined reporting, but expressed reservations about aspects of the legislation and stated that it would "continue to look for a comprehensive solution" as outlined by President Reagan. JA-746. The United States noted the California legislation had elements "inconsistent" with the President's statement (*inter alia*, the election fee), but suggested deferral of pending restrictive legislation to give California and other worldwide unitary states the opportunity to respond. Ex. 37I at 63-64.

6. SUBSEQUENT EVENTS.

Subsequent significant events, which have been called to the attention of this and other courts, have occurred.

Nations continued to lodge formal diplomatic protests with the United States and appeared as amici curiae in this and other litigation testing the constitutionality of worldwide combined reporting.[4]

On May 13, 1993, the United Kingdom announced that it would have to take retaliatory measures in relation to United States based companies if there was not a satisfactory resolution of the problem of the "internationally opposed unitary tax" on foreign-owned companies in California by the end of the year. PSA(1) N.

On June 30, 1993, the Finance Committee of the German Bundestag requested the German Government to take immediate steps to consider retaliation should it prove impossible to achieve a satisfactory solution to the problem of unitary taxation within a reasonable period of time. PSA(1) O.

In September, 1993, in direct response to foreign retaliatory pressures and persuasion by the Clinton Administration, California further amended its water's edge legislation effective for years beginning on or after January 1, 1994. PSA(1) L A-25; 1993 Cal. Stat. ch. 881.

On September 15, 1993, upon passage of these amendments to California's water's edge legislation, the United Kingdom announced that it would defer retaliatory action pending satisfactory application of such law. The United Kingdom reiterated its

[4]Letter from Ambassador of Spain Julian Santamaria to Secretary of State James Baker, dated June 30, 1989, attached to Brief Amicus Curiae on behalf of the Organization for Fair Treatment of International Investment (OFTII) and Union of Industrial and Employers' Confederations of Europe (UNICE), California Supreme Court; Note No. 91 from British Embassy to U.S. Department of State, dated July 22, 1992, attached to Amicus Curiae Brief of the Government of the United Kingdom, U.S. Supreme Court, No. 91-212; Note 30, USA, 6/1 from Royal Dutch Embassy to Secretary of State Warren Christopher, dated March 26, 1993, attached to Amicus Curiae Brief of the Member States of the European Communities and the Governments of Australia, Austria, Canada, Finland, Japan, Norway, Sweden and Switzerland, U.S. Supreme Court, No. 92-1384.

position that, while the legislation in California was a significant step forward, by itself it could not provide a complete solution to the unitary tax problem. PSA(1) P.

On September 23, 1993, the Member States of the European Community and the Commission of the European Communities sent a note to Secretary of State Warren Christopher characterizing the legislation as "an improvement," but expressing the view that the unitary tax problem was not solved. PSA(1) Q.

On October 14, 1993, the Governments of the Member States of the European Communities (Belgium, Denmark, France, Federal Republic of Germany, Greece, Ireland, Italy, Luxembourg, The Netherlands, Portugal, Spain and The United Kingdom) and the Governments of Australia, Austria, Canada, Finland, Japan, Norway, Sweden and Switzerland sent a note to the Secretary of State also stating that they did not consider the unitary tax problem resolved by the California legislation. PSA(2) R.

The United States opposed the granting of Barclays' second petition for certiorari after this Court requested its views. U.S. Am. Br., No. 92-1384. The United States did not disavow its prior positions that the application of the California method to foreign multinational enterprises was inconsistent with the established international practice to which the United States adhered, as well as a source of conflict, but contended that California's 1993 amendment of its water's edge legislation made the issue no longer one of recurring importance. *Id.*

7. THE ASSESSMENTS.

The California Franchise Tax Board audited the California tax returns of BBI and Barcal for 1977 and determined that BBI and Barcal were part of a worldwide unitary business conducted by the members of the Barclays Group. JA-11. The Franchise Tax Board assessed additional taxes of $4,076 to BBI and $254,699 to Barcal, subsequently reduced during the administrative process to $1,678 and $152,420, respectively. *Id.* BBI had originally filed its tax return for the income year 1977 on the basis that it was part of a unitary business composed of itself and its subsidiaries, but not its parent BBL and BBL's other subsidiaries. JA-12. BBI paid

with its original return $14,447.54. JA-11. Barcal had originally filed its tax return for the income year 1977 on an arm's length separate accounting basis and paid tax of $541,276.49. *Id.* Both BBI and Barcal protested the assessments on the basis, *inter alia*, that the correct method upon which to compute the tax was the arm's length separate accounting method. JA-12 to 13. The protests, later converted into claims for refund, were the basis upon which suit was brought. JA-13. BBI and Barcal paid the additional assessed taxes and filed suit for refund, challenging the constitutionality of the application of worldwide combined reporting to foreign-owned multinational groups. *Id.*

8. THE DECISIONS BELOW.

A. California Superior Court and Court of Appeal (First Opinion).

The California Superior Court held, and the California Court of Appeal affirmed, on the basis of substantial evidence,[5] that California's application of worldwide combined reporting to foreign-owned multinational groups violated the foreign Commerce Clause because it "impair[ed] federal uniformity in an area where federal uniformity is essential" and "prevent[ed] the Federal Government from 'speaking with one voice when regulating commercial relations with foreign governments.'" *Japan Line, Ltd. v. County of Los Angeles*, 441 U.S. 434, 448, 451 (1979).

Both courts rejected the contentions of the Franchise Tax Board that five factors showed a congressional policy "to permit the states to tax as they please" by "negative acquiescence" without congressional legislation. In light of the distinctions between this case and *Container Corp. of America v. Franchise Tax Board*, 463 U.S. 159 (1983), and the fundamental differences between the arm's length international standard and world-

[5]Although there were some stipulations, PA A-36, 70, *reprinted* at JA-8 to 49, the case was tried on a contested record. The Statement of Decision of the Superior Court (PA A) explains the factual and legal basis for its decision as to each of the controverted issues at trial. Cal. Civ. Proc. Code § 632.

wide combined reporting, both courts found that a direct adverse impact on foreign affairs from the use of worldwide combined reporting was "inevitable."[6]

The Court of Appeal also found a clear and thoroughly grounded policy of the Executive to require the use of the arm's length method to divide income of foreign multinational enterprises. That court further found that, in the face of congressional inertia and inaction and in an area where the Executive has traditionally been given great deference, this policy constituted a "clear federal directive" in favor of the arm's length method.

The Superior Court also found de facto discrimination amounting to economic protectionism against foreign owners because domestic enterprises did not have the compliance burdens which worldwide combined reporting placed on foreign-based multinational taxpayers. PA A-26 to 28. The Court of Appeal acknowledged that this legal analysis was based on substantial evidence, and mentioned that foreign anger was even more understandable "in light of the critical role the United States has played in attempting to construct a coherent and nondiscriminatory tax policy for all nations" based on separate accounting. PA B-26.

The Superior Court also ruled that the due process clauses of the California and United States Constitutions were violated. The first Court of Appeal opinion did not reach this issue.

B. California Supreme Court.

In reversing the decision of the Court of Appeal, the California Supreme Court recognized that it was "presented with a question left open in *Container*," PA C-3, but rejected analysis under the tests this Court set forth in *Container* and *Japan Line*. Rather, the

[6]The Court of Appeal affirmed the holding of the Superior Court that, even with the "definite risk of, as well as actual double taxation" in this case, worldwide combined reporting in this context did not fail the first additional test of *Japan Line* (double taxation). PA A-25 to 26; PA B-21. It is unclear if the Superior Court reached Barclays' contentions that the tax method also failed the first (nexus) and fourth (relation to services) tests of the dormant Commerce Clause. *See* PA A-21.

California court declared that *Wardair Canada v. Florida Department of Revenue*, 477 U.S. 1 (1986), had "reoriented" the dormant Commerce Clause and had reduced the scope for dormant Commerce Clause analysis so as to make such analysis "particularly inappropriate" in this case. PA C-19. Instead, "*Wardair* supplants what the court has termed the 'quagmire' of dormant commerce clause analysis . . . with a heightened judicial attentiveness to expressions of congressional foreign commerce policy." PA C-21 (citation omitted). The court "abstracted" from *Wardair* "a kind of protocol for identifying those kinds of governmental silences that give rise to 'negative implications' supporting an inference of federal acquiescence in the state tax under challenge." PA C-23.

The California court constructed its own test to determine whether a state tax violated the foreign Commerce Clause: whether in the absence of legislation, Congress' inaction constituted a "pattern of congressional action" which "evidences both an awareness of [the] issue and a refusal to adopt the remedy urged upon it . . . ." PA C-38. The court took the same five items which the lower courts had rejected as evidence of congressional policy and under its new test treated them as "those kinds of governmental silences . . . [implying] federal acquiescence in the state tax under challenge." PA C-23. The court never addressed the fact that this Court had considered the most important of these factors in *Container* (the failure of treaties to restrict or cover state taxes, Senate failure to pass the U.S.-U.K. Treaty with Article 9(4), no congressional legislation) as constituting neither explicit action nor congressional policy.

Because the "*Wardair* methodology interdict[ed] judicial resort to executive branch opinions as to the international commercial effect of a challenged state taxation practice . . . ," PA C-21, the California court rejected the views of the United States, appearing as amicus curiae, that California's use of worldwide combined reporting interfered with the "Federal Executive's conduct of foreign affairs." PA C-37 n.22.[7]

[7]The California court concluded that the "clear federal directive" test in *Container* was not part of the dormant Commerce Clause analysis.

Thus, the court did not consider the findings below of burden on commerce or the foreign policy implications in the application of worldwide combined reporting, including retaliation and threats of retaliation.

The court remanded the issues of the discriminatory effect of compliance burdens and due process to the Court of Appeal for further proceedings.

C. Court of Appeal (Second Opinion).

On remand, the Court of Appeal agreed that foreign-based corporate groups incurred significant administrative costs, greater than their domestic counterparts, to comply with the California system. PA D-9. However, the court concluded that the burdens were not unconstitutionally discriminatory because foreign and domestic corporations faced the same tax rate and had to furnish the same information, and because the burden was ostensibly alleviated by Regulation 25137-6, providing for the use of reasonable approximations. PA D-10 to 14.

The Court of Appeal further concluded that, in the context of a non-arbitrary application, Regulation 25137-6 did not result in unreasonable, undue or arbitrary costs of compliance and that the Regulation could be construed to contain constitutionally adequate standards to guide application of the Board's discretion to grant relief from the mandatory provisions of the Regulation. PA D-14 to 27.

SUMMARY OF ARGUMENT

This Court has recognized for well over 100 years that "the constitutional prohibition against state taxation of foreign commerce is broader than the protection afforded to interstate commerce. . ." *Kraft Gen. Foods, Inc. v. Iowa Dep't of Revenue and Fin.*, 112 S. Ct. 2365, 2370 (1992) (citing *Japan Line Ltd. v. County of Los Angeles*, 441 U.S. 434, 445-46 (1979)). Foreign commerce merits broader protection because "matters of concern

but served only to determine whether Congress had acted to preempt an otherwise valid state tax.

to the entire Nation are implicated." *Kraft*, 112 S. Ct. at 2370 (citing *Japan Line*, 441 U.S. at 448-51). State burdens on foreign commerce carry with them the potential for international retaliation that will harm and concern "the Nation as a whole," not just the offending state. *Japan Line*, 441 U.S. at 450. The broader protection accorded to foreign commerce also requires closer scrutiny in considering whether Congress has acted to permit such a burden. *South-Central Timber Dev., Inc. v. Wunnicke*, 467 U.S. 82, 92 n.7 (1984).

With these concerns in mind, this Court in *Container Corp. of America v. Franchise Tax Board*, 463 U.S. 159, 189 n.26 & 195 n.32 (1983), expressly reserved the issue of the constitutionality of worldwide combined reporting, when applied to foreign-owned taxpayers. This case squarely presents that reserved question.

Japan Line and *Container* itself set forth the tests for resolving this question: (a) whether the tax as applied impaired federal uniformity in an area where federal uniformity is essential and prevented the Nation from "speaking with one voice" when regulating foreign commerce; and (b) whether the tax as applied created a substantial risk of multiple taxation. Under both tests, worldwide combined reporting is unconstitutional as applied to foreign-owned multinationals.

The violation of the "one voice" test here is unmistakable: California's use of worldwide combined reporting to divide income of foreign multinational corporations understandably has offended all of the major trading partners of the United States and has led to both threats of and actual retaliation. As the United States itself has acknowledged, few issues have provoked so broad and intense a reaction from foreign nations. There is an accepted international standard — the arm's length method — which has attained the custom of nations. Worldwide combined reporting, on the other hand, is a separate and different method to divide income which is incompatible with the international standard. It is perceived by foreign nations as an arbitrary, unfair, and predatory method of taxation, the use of which threatens the international standard, imposes unreasonable tax and compliance burdens on foreign-owned taxpayers, and discourages foreign investment in the United States. California's intrusion into this

area deeply affecting the foreign relations of the Nation as a whole also has caused the United States to appear repeatedly as amicus curiae in this case — in the three California courts and in this Court over a period of six years and through five Administrations — to express its view that worldwide combined reporting was unconstitutional under the "one voice" test.

Regarding multiple taxation, this Court in *Container* found that worldwide combined reporting did present a risk of multiple taxation, but that such multiple taxation was not inevitable and the risk of it was not unconstitutional as applied to a *domestic* multinational. Here, there is no question that worldwide combined reporting in fact has resulted in actual multiple taxation of foreign multinationals. Further, such occurrences of actual multiple taxation of foreign multinationals, together with the ever-present risk of such multiple taxation, constitute a significant international irritant. The incidence of this risk on foreign-owned taxpayers, and the resulting impact on foreign relations, makes multiple taxation a different problem in this context than in the context of domestic multinationals, and implicates the very concerns underlying the foreign Commerce Clause. Accordingly, the risk of multiple taxation in and of itself establishes the unconstitutionality of worldwide combined reporting as applied to foreign multinationals.

In response to this patent unconstitutionality under the *Japan Line/Container* tests, California has advanced two arguments, neither of which withstands scrutiny. First, California has argued that the dormant Commerce Clause, including these tests, does not apply here at all, as a result of this Court's decision in *Wardair Canada v. Florida Department of Revenue*, 477 U.S. 1 (1986). This argument was the basis for the California Supreme Court's decision, which ignored the analytical framework used by this Court in *Japan Line* and *Container*. Second, California has argued that subsequent events somehow transform the analysis in determining the unconstitutionality of worldwide combined reporting.

First, nothing in *Wardair* changes the longstanding rule, followed by this Court in numerous cases both before and after *Wardair*, that Congress must act clearly and unambiguously to

remove a state enactment from the reach of the dormant Commerce Clause. This rule has been applied with especial rigor in the sensitive area of foreign commerce. The California Supreme Court's opinion turns this rule on its head by concluding that congressional silence constitutes "acquiescence" sufficient to preclude any application whatsoever of the dormant Commerce Clause. In fact, as this Court itself concluded in *Container*, there is no congressional legislation either specifically permitting or specifically forbidding the use by the states of worldwide combined reporting to divide international income for tax purposes. Congress as a whole has not addressed the issue at all, and, to the extent the Senate visited the issue in the course of considering the U.S./U.K. Tax Treaty, a majority of the Senate twice expressed its *opposition* to worldwide combined reporting. Accordingly, the dormant Commerce Clause tests do apply here and cannot be avoided.

Second, subsequent events in no way change, let alone cure, the unconstitutionality of California's tax system for a period exceeding twenty years. Whether or not California's most recent legislation passes constitutional muster is not before this Court. In any event, it is prospective only, and does not change the analysis here.

California's tax method as applied in this case is unconstitutional on additional grounds as well.

1. Foreign policy is the exclusive prerogative of the Federal Government. Where, as here, state action interferes with the conduct of foreign affairs by the Federal Government, the Constitution itself preempts such action.

2. Worldwide combined reporting imposes prohibitive compliance burdens on foreign multinationals, significantly greater than those imposed on domestic corporations. This discriminatory impact on foreign commerce in and of itself is violative of the foreign Commerce Clause under this Court's precedents.

3. Because foreign multinational taxpayers cannot comply with the mandatory filing provisions of the California worldwide filing regulation without inordinate cost, they must rely on acceptance of information in lieu thereof by California. The lack of

meaningful standards to provide guidance for exercise by California of the discretionary relief provision of the regulation constitutes a due process violation.

ARGUMENT

I. CALIFORNIA WORLDWIDE COMBINED REPORTING IS UNCONSTITUTIONAL UNDER THE FOREIGN COMMERCE CLAUSE.

A. This Court Has Established Criteria for Determining the Constitutionality of State Taxes Under the Foreign Commerce Clause.

A central concern of the Framers of the Constitution was that "to succeed, the new Union would have to avoid the tendencies toward economic Balkanization that had plagued relations among the Colonies and later among the States under the Articles of Confederation." *Hughes v. Oklahoma,* 441 U.S. 322, 325-26 (1979). The need for avoiding balkanization among the states is especially great with respect to foreign commerce, not only because of the concern that action by a single state might bring harm to the Nation as a whole, but also because of the need for the people of the United States to act through a single national voice on matters affecting the foreign relations of the entire country. *Wardair,* 477 U.S. at 8; *Japan Line,* 441 U.S. at 448-51; *Kraft,* 112 S. Ct. at 2370.

In the *Container* case, in concluding that worldwide combined reporting was constitutional when used to divide the international income of a domestic multinational enterprise, this Court determined that Congress had remained silent. Thus, the Court used a dormant Commerce Clause analysis, applicable when Congress has not affirmatively acted and where "it is the responsibility of the judiciary to determine whether action taken by state or local authorities unduly threatens the values the Commerce Clause was intended to serve. *See Southern Pacific Co. v. Arizona,* 325 U.S. 761 (1945)." *Wardair,* 477 U.S. at 7-8; *see also Japan Line,* 441 U.S. at 448-51.

This Court has adopted four tests under the dormant Commerce Clause to determine if a state tax satisfies basic interstate Commerce Clause requirements: (1) the tax must be applied to an activity with a substantial nexus with the taxing state; (2) the tax must be fairly apportioned; (3) the tax must not discriminate against interstate commerce; and (4) the tax must be fairly related to the services provided by the taxing state. *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274, 279 (1977). In *Japan Line*, this Court recognized the heightened need for uniformity in dealing with other nations when foreign commerce is implicated by adding two additional tests:

- whether the tax, notwithstanding apportionment, created a substantial risk of multiple taxation; and
- whether the tax impaired federal uniformity in an area where federal uniformity is essential and prevented the Nation from speaking with one voice when regulating foreign commerce.

Japan Line, 441 U.S. at 451.

With respect to multiple taxation, this Court pointed out that "[e]ven a slight overlapping of tax — a problem that might be deemed *de minimis* in a domestic context — assumes importance when sensitive matters of foreign relations and national sovereignty are concerned." *Id.* at 456. A tax could prevent the Nation from speaking with one voice and frustrate achievement of federal uniformity by leading to international disputes over reconciling apportionment formulae, by creating asymmetry in the international tax structure leading to retaliation which causes harm to the Nation as a whole, not just to the state, and by increasing the potential for varying degrees of multiple taxation should other states follow the taxing state. *Id.* at 450-51. This Court concluded in *Japan Line* that the California tax at issue there not only produced multiple taxation in fact but also prevented the Nation from speaking with one voice. *Id.* at 451-52.

In *Container*, which involved the same California taxation method at issue here but applied to a domestic-owned multinational group, this Court reaffirmed the two additional *Japan Line* tests. The Court reemphasized that "double taxation in the

foreign commerce context deserves to receive close scrutiny," 463 U.S. at 189, but found it constitutionally significant that: (1) the tax in *Container* was on income rather than property; (2) double taxation was not an "inevitable" result of the California taxing scheme; and (3) the tax fell not on a foreign-owned business but on "a corporation domiciled and headquartered in the United States." *Id.* at 187-89. Elaborating on the "one voice" inquiry, this Court stated that a state tax at variance with federal policy would fail the one voice standard if "it *either* implicates foreign policy issues which must be left to the Federal Government *or* violates a clear federal directive." *Id.* at 194.

The most obvious foreign policy implication of a state tax was the "threat it might pose of offending our foreign trading partners and leading them to retaliate against the Nation as a whole." *Id.* "[I]n the absence of explicit action by Congress," *id.*, to determine when foreign nations would be offended, this Court developed "objective standards" reflecting general observations about the imperatives of international trade and foreign relations. *Id.* When applied in the factual context of *Container, i.e.*, taxation of a domestic multinational enterprise, these factors weighed against the conclusion that the California tax might justifiably lead to foreign retaliation: the tax did not create automatic asymmetry in international taxation; the tax fell not on a foreign entity but on a domestic corporation; and, even if foreign nations had a legitimate interest in reducing tax burdens of domestic corporations, the amount of tax paid by the domestic taxpayer was more a function of the tax rate than the allocation method. *Id.* at 194-95. Finally, while stating that a state tax might have foreign policy implications other than the threat of retaliation, this Court noted the absence of an amicus brief by the Executive Branch. *Id.* at 195-96.

The Court then turned to the other prong of its test, violation of a clear federal directive, a "species" of preemption. This Court held that the failure of treaties to cover subnational taxes or to restrict states to the arm's length method, the failure of the Senate to pass the U.S.-U.K. Treaty with a provision that would have restricted state use of a non-arm's length method, and the failure of Congress to enact legislation restricting state taxation,

did *not* constitute preempting "specific indications of congressional intent." *Id.* at 196.

B. Tested by this Court's Criteria, Worldwide Combined Reporting as Applied here Is Unconstitutional.

This case involves the most obvious and unconstitutional foreign policy implication of a state tax: the threat of offense to our foreign trading partners leading to risk of, and actual, retaliation. It also involves clear frustration of U.S. policy, actual double tax, and aggravated risk of double tax. Tested by the criteria of *Japan Line* and *Container,* application of worldwide combined reporting to members of a foreign-owned multinational group, as here, is unconstitutional under the dormant foreign Commerce Clause.

1. Worldwide Combined Reporting Interferes with the Ability of the United States to Speak with One Voice.

Worldwide combined reporting undeniably implicates foreign policy issues which must be left to the Federal Government and prevents the Nation from speaking with one voice. Foreign nations have properly communicated their concerns not only over the burdens on their nationals from the inconsistent worldwide combined reporting system, but also over the possible unravelling of sixty years of cooperative effort among nations to establish the arm's length method as the exclusive international standard. Thus, this Court need not speculate as to the foreign policy implications of the application of the California method to foreign-owned enterprises. Whether measured under the "objective standards that reflect very general observations about the imperatives of international trade and international relations" as set forth by this Court in *Container*, 463 U.S. at 194, or under this Court's longstanding jurisprudence recognizing the special need for uniformity in external affairs, the application of the California method to divide the income of a foreign multinational enterprise clearly fails the "one voice" test.

a. Use of a Method Other than the International Standard Frustrates United States Policy and United States Trading Partners.

There is an express and well articulated policy of the United States on the system to be used for division of income of foreign multinational enterprises among nations for tax purposes. It is the arm's length method. JA-577, 600 to 603. The United States does not stand alone in selecting that standard. It is used by every major trading partner of the United States. JA-70, 600 to 03. No other method is used internationally. PA A-20.

As a result, foreign governments have bombarded the United States with steadily escalating complaints from the moment of California's application in the 1970's of worldwide combined reporting to foreign multinational enterprises. PA A-17, 24; JA-770 to 74. Few issues have provoked as broad and intense a reaction from foreign nations. JA-576. The reason is obvious: the intrusion of this different and incompatible method threatens to negate the over 60 years of effort by the United States and most of the developed and developing nations of this world in standardizing rules for the allocation of income to jurisdictions for the purposes of taxation. JA-98, 821 to 22; R 1129.

As part of its own economic policies, the United States has been a leader in fostering use of this method. R 63-64, 1138-39, 1168-69. The stakes involve more than a desire for orderliness. Harmonization of tax systems has been recognized by the United States as essential to its policy of free trade to encourage foreign investments in the United States, as well as to remove barriers to U.S. investment abroad. JA-86 to 87, 769, 822 to 23; Ex. 50B at 9.

The success of this effort is reflected in the network of treaties, model treaties, internal laws and cooperative efforts among nations. JA-822. The arm's length standard is the custom of nations. PA A-20; JA-813, 823 to 24, 826; R 1129-32.

Strong policy reasons underlie the use of a single standard. For international business, the use of an agreed upon standard: (i) mitigates the possibility of unrelieved multiple taxation by reducing the number of nations that claim the right to tax the

same income, R 1139-41; (ii) gives predictability for planning, R 1151-52; and (iii) harmonizes tax compliance requirements, *see* JA-77, 84 to 85. From the standpoint of nations, the use of a single standard is even more important: it sets the boundaries of a nation's claim to tax income, it protects that nation's commerce and trade by delineating the rules under which its nationals are taxed abroad, and it provides a consistent and uniform framework to discuss and resolve difficult and sensitive issues of international taxation.

Under the arm's length standard, each corporation is treated as a separate entity. JA-823 to 24; R 1124-25, 1172. A nation, while retaining the right to tax its domiciliaries in any way it wants, will tax a corporation, the ultimate ownership of which is foreign, only on the profits of that corporation in the host country and will not tax related corporations not otherwise present. JA-821; R 1125-26, 1172. Each jurisdiction customarily retains the right to examine transactions between related entities and to determine whether the transactions are done on a basis which is a realistic and economic reflection of the income of the parties. *See* Ex. 37I at 3 to 4; R 1126-28.

In contrast, worldwide combined reporting requires aggregation of the income of each entity which is a member of the so-called unitary group (whether or not doing business in the taxing jurisdiction) and determines the tax jurisdiction's share of this total tax base by a formula, usually an average of property, payroll and sales. PA A-21. Its underlying economic assumption, that the activity of the worldwide unitary business is equally profitable in all jurisdictions, conflicts with recognition under the arm's length method that an individual corporation operating under different market conditions can and will earn different rates of return. Ex. 37C at 35; Ex. 46N.

Nations have worked out formal and informal mechanisms to reconcile differences in the application of the arm's length method. JA-822 to 25; R 1154, 1166-67. There are no mechanisms available or possible to reconcile differences between the arm's length method and worldwide combined reporting. *See* JA-781, 824; R 1168-69.

Against this practical and historical background, both the United States and foreign governments have been seriously concerned about the implications of permitting worldwide combined reporting to exist concurrently with the arm's length method.

The United States cannot unilaterally enforce a particular standard for the division of multinational income among nations. It must instead depend on the cooperation and agreement of other nations. R 1167. The United States cannot insure that cooperation when a state frustrates the very purposes of an international standard by using a different and incompatible method. Thus, the use by the states of worldwide combined reporting has interfered with the United States' conduct of its foreign economic policy, of which the international standard is a part.

b. Use of Worldwide Combined Reporting in These Circumstances Results in the Clearest Foreign Policy Implication, Risk of Retaliation.

Use by a subnational unit of a method different than that used by its sovereign to allocate international income subverts the very purpose of the agreed upon standard. Foreign nations are offended. Such offense has led to threats of and actual retaliation. No state has the right to provoke such a response. *Japan Line*, 441 U.S. at 450-51.

Foreign offense here has been intensified because foreign nations perceive worldwide combined reporting as an arbitrary, unfair and predatory method of taxation. PA A-21. In their view this method threatens the international standard, imposes unreasonable tax and compliance burdens on foreign-owned taxpayers and discourages foreign investment in the United States. JA-775, 792-93; Ex. 37C at 34. The United States has agreed with these characterizations. JA-575 to 79, 775 to 79.

Unlike *Container*, this Court need not speculate here as to the offense and its result. The California Court of Appeal, in its first opinion affirming the trial court's findings on the basis of substantial evidence, summarized:

> Every single nation in the industrialized western world has sent letters to the United States government protesting the

use of WWCR by American states. Many of these protests have also been directed to California. Among the most vigorous of these remonstrators has been Canada, by far the United States' largest trading partner, and Britain, this country's largest foreign investor. These protests have been sharp, frequent, and incessant over a number of years. There was also evidence that no other taxation issue had ever led foreign governments to deal directly with American states. Even high-placed officials of the Board acknowledged awareness of this international outcry.

PA B-22. The record contains over 35 demarches and other diplomatic communications, not just to the United States but even to the states themselves, all protesting use of this method. *See* JA-93 to 126, 129-40. These protests have continued. *See* p. 10, *infra.*

The dispute reached the highest level: Prime Minister Thatcher of the United Kingdom, Prime Minister Trudeau of Canada, and Prime Minister Nakasone of Japan all spoke or wrote to the President. JA-131, 753, 772 to 73.

Foreign offense led to more serious action and harm to the Nation. As the California Court of Appeal described:

> And it is not just talk. The ultimate test of diplomatic sincerity — watch what they do, not what they say — has been met here. In 1985, Britain passed retaliatory legislation withdrawing a tax advantage for U.S.-based corporations doing business in both Britain and a unitary tax state. Though Britain stopped short of pulling the procedural trigger to fully implement this legislation, the law had a retroactive provision that propelled many American companies into preimplementation compliance. Moreover, Britain cancelled a trade mission to Florida because that state applied WWCR to foreign-based multinationals. And there were other similar cancellations. There was also evidence the United States has had problems in negotiating treaties because of objections to WWCR.

PA B-22 to 23. *See also* JA-127 to 28, 575 to 79, 600 to 03.

The British retaliatory legislation is the most obvious foreign policy implication, but there were numerous others. The West Germans and the Dutch delayed treaty negotiations. JA-782. The French and Canadians insisted on an agreement to reopen treaty negotiations if an acceptable solution could be found. JA-478, 481 to 82, 570 to 71. The matter has consumed the time and resources of the United States and its trading partners as well as causing embarrassment to both. JA-780 to 81. As George Carlson, a senior Treasury official, testified, the United States was asked if it had one foreign policy or 51 foreign policies. JA-781.

What was the response of the United States? Through six Administrations, commencing with President Nixon, the Federal Executive has sought to limit the states' use of worldwide combined reporting in the international sphere. PA B-29 to 30; JA-771. The efforts by the Federal Executive, beginning with the addition of Article 9(4) to the U.S.-U.K. Treaty in the Nixon administration and continuing through the administrations of President Ford, President Carter, President Reagan, and President Bush, were consistent and constant.[8] PA A-19, 21; PA B-29 to 30; JA-783 to 86.

Secretary of State George Shultz warned the unitary states in letters to their governors, including California's:

> Your state's employment of the worldwide unitary method of tax accounting is at odds with the position of the United States and has become a source of conflict with foreign states.

JA-601. Further, the United States appeared as amicus curiae in this case in the three California courts, and in this Court in

[8]These consistent efforts were sufficient for the California Court of Appeal to conclude that these constituted a "clear federal directive" which the application of worldwide combined reporting unconstitutionally violated. PA B-35. The record in this case ends during the Reagan administration. However, the United States continued to appear in this case as amicus curiae during the Bush administration. The Clinton administration's efforts in securing the 1993 California legislation are described in the California Legislative Committee Report at PSA(1) L A-25.

support of Barclay's first petition for certiorari, each time pointing out the severe effects upon United States foreign economic policy and condemning the method as unconstitutional.[9]

c. Whether Tested Under this Court's *Container* "Objective Factors" or Other Jurisprudence, the California Tax Method Leads to Justifiable Retaliation.

The record in this case overwhelmingly demonstrates the unconstitutional interference with foreign relations which the use of worldwide combined reporting creates in these circumstances. Under the tests of both *Container* and *Japan Line* this should be sufficient. Comparison with the "objective factors" of *Container* to determine if use of the tax might lead to justifiable retaliation is unnecessary here: the Court has clear evidence both of retaliation and its justification.[10] *Hines v. Davidowitz*, 312 U.S. 52, 63-64 (1941).

Nevertheless, this Court's "objective factors" reflecting the "imperatives of international trade" confirm that foreign nations are likely to retaliate and are justified in retaliating in exactly the circumstances herein.

(i) Automatic Asymmetry

First, there is automatic asymmetry in the system of international taxation to the disadvantage of foreign multinationals when states apply worldwide combined reporting to them. United States

[9]PA H-25 n.13; PSA(1) K A-13. In its most recent appearance in opposition to the grant of certiorari, the United States did not disavow its previous position that imposition of this method constituted a constitutional violation. U.S. Am. Br., No. 92-1384.

[10]This Court needed the "objective factors" in *Container* because it was dealing with a domestic multinational enterprise whose sovereign was the United States. Inconsistent treatment of domestic multinational enterprises, although perhaps undermining other values, could not *directly* affect rights of other nations. Thus, this Court could determine under the objective factors that retaliation, a response available only to a foreign sovereign, would not be appropriate or likely.

businesses are not subjected to this tax method by any nation. PA A-20; JA-821.

That the taxpayers are foreign clearly affects the risk of retaliation from such asymmetry. In *Container*, involving a domestic multinational, this Court considered only "inevitable" double taxation as creating asymmetry of constitutional significance. 463 U.S. at 188. However, in *Japan Line*, in the foreign context, this Court looked to the "competitive disadvantage" to foreign business from the use of inconsistent tax systems internationally, and the reaction of the affected government to this disadvantage. *Japan Line*, 441 U.S. at 453.

The double taxation present in *Japan Line* was one such disadvantage, but inconsistent tax systems can produce other disadvantages to a foreign taxpayer—and to a foreign sovereign—that can result in retaliation for many reasons. Matters *de minimis* in a domestic context become important where issues of national sovereignty are concerned. *Japan Line*, 441 U.S. at 456.

There is actual double taxation here and aggravated risk of double taxation from the inconsistent systems. PA A-25. Foreign multinational enterprises face greater exposure to risk of double taxation in these circumstances than do domestic multinational enterprises. PA A-26. Whether or not the aggravated risk of double taxation is sufficient in and of itself to make California's method unconstitutional (*see infra* subsection 2), it is certainly an important factor in gauging its impact on foreign relations for purposes of the "one voice" test. *See* JA-814.

Moreover, this type of double taxation affects the foreign sovereign. JA-779. Nations use the international standard as a means of limiting and managing double taxation. JA-822 to 23. As this Court recognized in *Container*, the potential for double taxation from differences in administrative interpretation is contemplated under the international standard and mechanisms exist to mitigate, if not eliminate, such double taxation. *See* 463 U.S. at 190-93. However, in the type of double taxation created here from a completely different and inconsistent system, the foreign nation is now being asked to accept degrees of multiple taxation stemming not from differences in administration, but from differences

in the basic allocation of rights to tax. Thus, a foreign nation loses the protective limits of the single standard, and the benefit of the bargain.

The interference is magnified because the resolution of double taxation issues may affect the foreign sovereign's treasury. If a corporation pays multiple taxes because of an aberrant system, there is less revenue for the domiciliary nation to tax, and there is also pressure on the domiciliary nation from its own nationals to relieve such additional taxation (usually by credit) at a cost to its own revenues. JA-779, 826 to 830. If the foreign nation refuses to do so, its own nationals bear the cost. See JA-74 to 75, 824 to 25. The direct interference with sovereign rights from this asymmetric tax is inescapable.

Further, the divergence in systems creates compliance burdens which a taxpayer does not face under the international system. PA A-26 to 29. Worldwide combined reporting requires the ongoing collection of worldwide tax information and translation into a worldwide state tax base under state tax accounting principles for all entities in the unitary group. PA A-27. Under the international system foreign businesses need not collect such worldwide information and certainly not in accordance with state tax accounting principles. PA A-26 to 27. Again, whether or not compliance burdens are unconstitutional in and of themselves, (*see infra* Part III), they indisputably offend foreign nations and are an important part of the analysis under the "one voice" test.

(ii) Incidence of Tax

The second objective factor is the incidence of tax. Here the incidence of tax falls directly on a foreign taxpayer as well as on a domestic subsidiary of a foreign affiliate, the *Japan Line* "side" of the equation. The "effective" incidence is on the foreign group. PA A-24; PA B-24.

This impact on foreign enterprises is constitutionally significant not only under *Japan Line* and *Container* but also other jurisprudence of this Court. This Court has long recognized that foreign governments have legitimate concerns over the protection of the rights of their nationals when such nationals are in another country. *Hines*, 312 U.S. at 64. Grave international controversies

"may arise from real or imagined wrongs to another's subjects inflicted, or permitted, by a government." *Id; see also Japan Line*, 441 U.S. at 450-51; *Chy Lung v. Freeman*, 92 U.S. 275, 279 (1875). Thus, that a foreign business is involved, whether directly as a taxpayer or indirectly as the ultimate parent, *see Franchise Tax Bd. v. Alcan Aluminium Ltd.*, 493 U.S. 331, 339 (1990), "concerns our international relations, in regard to which foreign nations ought to be considered and their rights respected." *Henderson v. Mayor of New York*, 92 U.S. 259, 273 (1875).

Accordingly, under the second objective factor, here retaliation is again foreseeable and proper.

(iii) Allocation method

Third, it is clear that the allocation method, not the tax rate, creates the problem. Here, the offense of foreign governments is not attenuated, it is immediate. Such governments are not only concerned that their taxpayers may pay more tax, they are also concerned that the unorthodox California system strips away the protections of the international standard. One of the purposes of the international standard is to avoid precisely the kind of administrative burdens and uncertainties which the incompatible California tax system produces. As described in Part III below, foreign taxpayers must either create a costly information gathering structure solely to comply with the California filing requirements or forego California tax benefits. PA A-27 to 28. If they file with California's so-called relief provisions, foreign multinational taxpayers pay on a different income base than their domestic counterparts. PA A-28; JA-788 to 91. Whether or not foreign businesses are paying too much tax, it is clear that they are paying a different amount of tax than domestic enterprises. Ex. 37A at 50. Measured in the realistic context of the international custom, it is the incompatible system, not the tax rate, which creates the retaliatory offense.

d. Foreign Policy Implications Have Continued.

The continuing Federal Government efforts to resolve the issue both before and after the U.S.-U.K. Treaty have been matched by foreign efforts through diplomatic and even non-diplomatic chan-

nels. *See* p. 10 *infra*. Thus, United States foreign policy continues to be implicated.

No state, not even California, may tell the United States, the United Kingdom or any nation how to conduct its foreign policy. *Japan Line*, 441 U.S. at 445; *Chy Lung*, 92 U.S. at 279; *Zschernig v. Miller*, 389 U.S. 429, 440-441 (1968).

2. California's Method Also Fails Under the Double Taxation Test.

Like the taxpayer in *Japan Line*, and unlike the taxpayer in *Container, see* 463 U.S. at 187 n.22, the taxpayers here unquestionably have established that double taxation has occurred. The Barclays Group placed its foreign tax returns in evidence. Ex. 52A to NN. On that and other evidence, the trial court found actual double taxation of BBI and Barcal, as well as a "more aggravated" risk, in general, of double taxation of foreign multinationals as compared to the domestic multinationals before the Court in *Container*. PA A-25 to 26.

The incidence of double taxation on foreign-owned, as opposed to domestic-owned, taxpayers is constitutionally significant. The *Container* Court itself emphasized the significance, for double taxation purposes, of the fact that the double taxation there fell on domestic-owned rather than foreign-owned taxpayers. 463 U.S. at 188-89. In *Container*, this incidence of tax was a critical factor outweighing the numerous "important" factors the Court identified as cutting *against* the constitutionality of worldwide combined reporting, even as applied to domestic-owned taxpayers. *See id.* at 187-93. These important factors militating toward unconstitutionality, taken from *Japan Line*, included the facts that: (1) "double taxation stems from a serious divergence in the taxing schemes adopted by California and the foreign taxing authorities," *id.* at 187; (2) "the taxing method adopted by those foreign taxing authorities is consistent with accepted international practice," *id.*; and (3) "our own Federal Government, to the degree it has spoken, seems to prefer the taxing method adopted by the international community to the taxing method adopted by California," *id.* All of these important factors indicating unconstitutionality are present here as well, and here — unlike *Container* —

the double taxation falls on foreign-owned rather than domestic-owned taxpayers.

The distinction for these purposes between foreign-owned and domestic-owned taxpayers is important both as a practical matter and in terms of the policies underlying the foreign Commerce Clause. Because foreign multinationals typically have more of their operations and entities outside of the United States, the breadth of double taxation and the degree of burden on foreign commerce are greater than in the case of domestic multinationals, which typically have a smaller share of their operations and entities outside of the United States. PA A-23. This impact is dramatically illustrated by the facts of this case: only three of the over 220 entities in the Barclays Group did any business at all in the United States. *Id.* In contrast, the large number of Barclays entities that did not do any business in the United States did do business in a total of 59 countries other than the United States, and over 98 percent of the revenue of the Barclays Group was received in countries other than the United States. *Id.* Since all of these other nations use the arm's length method (as the United States itself does at the national level), Barclays is subject to tax on these operations by all of these other nations. At the same time, because California's worldwide combined reporting method requires the taxpayers here to include all of these foreign operations in the tax base for California as well, the double taxation is actual and severe, as it was on the foreign-owned taxpayer in *Japan Line*.

That the tax here falls on the *Japan Line*, rather than the *Container*, side of the scale on the double taxation issue is further underscored by this Court's most recent analysis of the double taxation issue in *Itel Containers Int'l Corp. v. Huddleston*, 113 S. Ct. 1095 (1993). There, in upholding the constitutionality of a Tennessee sales tax imposed on a domestic container company, this Court emphasized: first, that the tax there fell on "a discrete transaction occurring *within* the State," *id.* at 1104 (emphasis added); and, second, that the state there gave a *credit* against its own tax for any tax paid in another jurisdiction on the same transaction, thereby "reduc[ing], if not eliminat[ing], the risk of multiple international taxation." *Id.* These very same

factors supporting the constitutionality of the tax in *Itel* point in the opposite direction here: California's worldwide combined reporting method includes operations *around the world* in its tax base; and California does *not* give any credit (or even a deduction) for taxes paid in foreign nations on operations in those nations. Cal. Rev. & Tax. Code §§ 23051.5(b)(7), 24345.

Although under the international standard mechanisms exist to resolve or mitigate double taxation, there is no way to resolve the double taxation created here. JA-824 to 25. Because California's system ignores the concept of geographic source of income (but instead takes a "slice" from everywhere), nations cannot even begin to resolve competing claims with California. See R 1175, 1188-1200. Nor can this Court sit as a tribunal to resolve such competing claims as it does in interstate commerce. *Japan Line*, 441 U.S. at 454. Since other states have in the past used and still use variations on worldwide combined reporting, a taxpayer is faced with varying degrees of multiple taxation with no way to resolve or mitigate these. All this the Court foresaw in *Japan Line*. All this has happened here.

For all these reasons, the tax here fails under the double taxation test.

C. Neither the *Wardair* Case nor Subsequent Events Support the Constitutionality of Worldwide Combined Reporting Applied in this Context.

In response to this patent unconstitutionality under the *Japan Line/Container* tests, California has advanced two arguments in an attempt to avoid application of those tests to the circumstances of this case. First, California has argued that the dormant Commerce Clause, including these tests, does not apply here at all as a result of this Court's decision in *Wardair*. PA C-26. Second, California argued below that subsequent events transform the analysis in determining the unconstitutionality of worldwide combined reporting. Neither argument withstands scrutiny.

1. *Wardair* Does Not Supplant this Court's Well-Established Dormant Commerce Clause Analysis.

In its opinion the California Supreme Court ignored this Court's well-established dormant Commerce Clause analysis on the basis that *Wardair* had supplanted such analysis. PA C-21 to 38. The court "abstracted" from *Wardair* "a kind of protocol for identifying those kinds of governmental silences that give rise to 'negative implications' supporting an inference of federal acquiescence in the state tax under challenge." PA C-23.

In fact, the California court's approach, patching together a number of unrelated Congressional "non-actions" into a "mosaic" of "acquiescence," has no basis in *Wardair* or any other jurisprudence of this Court.

a. *Wardair* Involved Clear and Affirmative Congressional Action.

Wardair concerned a state sales tax on a discrete transaction (purchase of fuel in Florida) occurring only within one national jurisdiction and including neither actual nor possible international multiple taxation. In *Wardair*, this Court strongly reaffirmed the policies of the dormant Commerce Clause, including a greater need for uniformity in the area of foreign commerce, but determined that the federal policy urged by the petitioner, reciprocal tax exemptions for aircraft, did not exist. On the contrary, "in the context of this case," the evidence demonstrated that the federal government had "affirmatively acted, rather than remained silent, with respect to the power of the States to tax aviation fuel." *Wardair*, 477 U.S. at 9. Congressional action constituting law came from the Chicago Convention, a treaty entered into by the United States and 156 other nations, which by its terms precluded the imposition of local taxes on fuel in certain circumstances but did not prohibit the taxation of fuel in the circumstances before the Court. This text demonstrated:

> the international community's awareness of the problem of state and local taxation of international air travel, specifically aviation fuel, and represent[ed] a decision by the parties to that Convention to address the problem by curtailing and

> limiting only some of the localities' power to tax, while implicitly preserving other aspects of that authority.

Wardair, 477 U.S. at 10. Subsequent treaties, including the United States/Canadian Treaty, dealt only with national taxes, leading to the inference that Congress had "negatively acquiesced" in the Florida tax. That conclusion was bolstered by (i) the existence of Canadian provincial taxes similar to that of Florida (an indication that there was no uniform policy and thus no national consensus against such taxes); and (ii) the lack of any challenge to the localities' tax until recently.

This Court emphasized several times in *Wardair* that its decision was in the context of the case and explicitly said that it was not addressing — and the opinion should not be understood as addressing — whether, in the absence of these international agreements, the foreign Commerce Clause would invalidate Florida's tax. *Wardair*, 477 U.S. at 13.

This Court proceeded in *Wardair* against an extensive background of enacted congressional legislation — the Federal Aviation Act domestically and the Chicago Convention internationally — both of which dealt with state sales taxes and the latter with state sales taxes on aviation fuel. *See* Frederick R. Fucci, *Allowing State Taxation of Foreign Carrier's Fuel: Wardair Canada, Inc. v. Florida Department of Revenue*, 40 Tax Law. 419 (1987). In contrast, in this case there is no seminal statute or other enactment which addresses the specific problem and represents international agreement. On the contrary, there is vehement and unrelenting international opposition. This case, involving worldwide activities in a myriad of nations and conflict with a well established international standard, is a far cry from the discrete sales tax of *Wardair* touching only one nation.

b. Clear and Affirmative Congressional Action is Required to Supplant Dormant Commerce Clause Analysis.

Nothing in *Wardair* changes the longstanding rule, followed by this Court in numerous cases both before and after *Wardair*, that Congress must act clearly and unambiguously to remove a state

enactment from the reach of the dormant Commerce Clause. "Congress must manifest its unambiguous intent before a federal statute will be read to permit or approve of such a violation of the commerce clause. . . ." *Wyoming v. Oklahoma*, 112 S. Ct. 789, 802 (1992); *see also Maine v. Taylor*, 477 U.S. 131, 139 (1986); *South-Central Timber Dev., Inc. v. Wunnicke*, 467 U.S. 82, 91; *Sporhase v. Nebraska ex rel. Douglas*, 458 U.S. 941, 960 (1982). The burden rests on the state to demonstrate such clear and unambiguous intent. *Wyoming v. Oklahoma*, 112 S. Ct. at 802.

The need for affirmative approval of the state statute or regulation is "heightened" when the statute has "substantial ramifications beyond the Nation's borders." *South-Central Timber*, 467 U.S. at 92 n.7. A consistent and coherent foreign policy, the exclusive responsibility of the Federal Government, requires that "congressional authorization not be lightly implied." *Id.*

This Court has held that congressional intent was not demonstrated by: (i) the reservation to the states of the regulation of local utility rates in the Federal Power Act (*Wyoming v. Oklahoma*); (ii) consistency of state regulation with federal legislation (*South-Central Timber*); (iii) deferral by Congress to state law in 37 statutes (*Sporhase*); or (iv) approval by Congress of several interstate water compacts (*id.*). The congressional enactment must be "an affirmative grant of power to the states to burden . . . commerce 'in a manner which would otherwise not be permissible.' *Southern Pacific Co. v. Arizona ex rel. Sullivan* [325 U.S. 761,] 769 [(1945)]." *New England Power Co. v. New Hampshire*, 455 U.S. 331, 341 (1982).

Itel Containers Int'l Corp. v. Huddleston, 113 S.Ct. 1095 (1993), reaffirms the applicability of dormant Commerce Clause analysis in the absence of a specific congressional enactment. In that case, involving a sales tax on container leases, this Court used the dormant Commerce Clause analysis of *Japan Line* and *Container* in determining whether the Tennessee tax created substantial risk of international double taxation or interfered with the nation's ability to speak with one voice. *Id.* at 1104. Some congressional action prohibiting certain types of state taxes but not the tax at issue, conjoined with the statement by the United States, appearing as amicus curiae, that the Tennessee tax did not

conflict with international custom, supported this Court's conclusion that the Tennessee tax did not violate the "one voice" prong of this Court's dormant Commerce Clause analysis. This Court found no preemptive force in such nonspecific enactments. *Id.* at 1102.

In this case there is no federal enactment which would even suggest any grant of power to the states to use a method contrary to the international standard. The California court opinion is just a variation on the old argument that states are free to tax as they choose until Congress stops them. This approach would, of course, eliminate the dormant Commerce Clause. This Court responded to a similar argument by California in *Japan Line*:

> The premise of appellees' argument is that a State is free to impose demonstrable burdens on commerce, so long as Congress has not pre-empted the field by affirmative regulation. But it long has been "accepted constitutional doctrine that the commerce clause, without the aid of Congressional legislation . . . affords some protection from state legislation inimical to the national commerce, and that in such cases, where Congress has not acted, this Court, and not the state legislature, is under the Commerce Clause the final arbiter of the competing demands of state and national interests." *Southern Pac. Co. v. Arizona ex rel. Sullivan,* 325 U.S. 761, 769 (1945). *Accord, Hughes v. Oklahoma, ante* at 326, and n.2; *Boston Stock Exch. v. State Tax Comm'n,* 429 U.S. 318, 328 (1977).

441 U.S. at 454-55. *See also Wyoming v. Oklahoma,* 112 S. Ct. at 802. In the sensitive area of foreign commerce, to permit a state to even act in matters directly affecting international relations seriously threatens the basic constitutional allocations of power between the federal government and the states. *See also infra* Part II.

This Court's *Kraft, Itel* and *Wyoming v. Oklahoma* decisions, subsequent to *Wardair*, confirm that *Wardair* suggests neither a change in course on sensitivity to foreign commerce nor the retrenchment claimed by the California court in the need for clear

and affirmative congressional approval to remove cases from the reach of the dormant Commerce Clause.

c. The Decision of the California Supreme Court Contradicts the Conclusions of this Court in *Container.*

The California court's determination that *Wardair* had "re-oriented" dormant Commerce Clause analysis also contradicts the conclusions of this Court in *Container.*[11] This Court in *Container* specifically held that the failure of treaties to cover subnational taxes or to restrict states to the arm's length method, failure of the Senate to pass the U.S.-U.K. Treaty with a provision which would have restricted state use of a non-arm's length method, and failure of Congress to enact legislation restricting state taxation did not constitute "specific indications of Congressional intent." *Container,* 463 U.S. at 196. Nevertheless, the California court relied on the same items as evidence of congressional "acquiescence" amounting to ratification of the state's use of worldwide combined reporting. PA C-34.

If such items evidence a congressional policy sufficient to remove this case from the dormant Commerce Clause, why did this Court bother with its analysis in *Container*, grounded as it is on the "absence of explicit action by Congress" and "no specific indications of Congressional intent." *Container*, 463 U.S. at 194, 196.

As this Court has recognized, Congress as a whole has not addressed at all the issue of a state's use of worldwide combined reporting to divide international income of foreign multinational enterprises. To the extent the Senate visited the issue in the course of considering the U.S.-U.K. Tax Treaty in 1978, a majority of the Senate twice expressed its *opposition* to worldwide combined reporting. *See supra* p.8. Nevertheless, the California

[11]The California court never considered why this Court's discussion of California worldwide combined reporting subsequent to *Wardair* continues to refer to both *Japan Line* and *Container* as the controlling precedents without mentioning *Wardair* or "reorientation." *See Franchise Tax Bd. v. Alcan Aluminium, Ltd.*, 493 U.S. 331, 334-35.

court would have the stalemate created by the minority in the Senate over Article 9(4) become an explicit "refusal" to act, and "evidence" of Congress' "exercise" of its power to regulate commerce. On the contrary, this sequence of votes, if anything, indicates a Senate *preference* to restrict states' use of worldwide combined reporting.[12]

The California court's other "items" (failure of Congress to enact legislation, omission of state taxes from bilateral tax treaties, and treaties of friendship, commerce and navigation) are remote and general. Congressional legislation never dealt exclusively with the application of worldwide combined reporting in the foreign context and none of the legislation ever came to a vote in committee or in either house of Congress. *See* p. 9, *supra.* Many of the bilateral tax treaties preceded the advent of the application of worldwide combined reporting to foreign enterprises and, except for Article 9(4), never dealt with worldwide combined reporting or even state taxes (except in nonsubstantive discrimination clauses). The Treaties of Friendship, Commerce and Navigation in the record also preceded the application of worldwide combined reporting to foreign multinationals and, contrary to the California court, the commentary to the U.S. State Department Standard Draft Treaty makes clear that the allocation language cited was intended to prevent divergence from the international standard. *See* Ex. 33C at 202 n.12. *See also* A.W. Granwell et al., *Worldwide Unitary Tax: Is It Invalid under Treaties of Friendship, Commerce and Navigation?*, 18 Law & Pol'y Int'l Bus. 695, 735-740 (1986). Finally, the conduct of the Federal Executive, both before and after the negotiation of Article 9(4), reflected a consistent policy of limitation of the application of worldwide combined reporting to foreign multinationals to the water's edge of the United States.

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[12]The reservation was added to the treaty without a vote because proponents of the reservation feared another defeat and proponents of the treaty did not wish to be seen as supporting the reservation. JA-406 to 07. The record also indicates that certain of the opposition was not to limiting states' use of worldwide combined reporting, but to the use of the Treaty as the mechanism. *See, e.g.*, JA-251, 278.

d. "Awareness" Is Not a Substitute for Affirmative Legislation.

This Court in *Wardair* relied upon legislation dealing with the problem at hand. This Court emphasized not only the international community's awareness of the specific problem at issue, but also its agreement to a particular solution evidenced by a legislative text in the form of the Chicago Convention, signed and executed by 157 signatories. No such text exists here, and, as the record clearly demonstrates, no such international consensus on the "solution" which the California court proposes, namely to let the states tax as they please. However, there is certainly an international consensus not to permit the application of this aberrant method to foreign enterprises. The California court's approach is not a careful mosaic, but a kaleidoscope in which it twists the various pieces into different patterns to suit the moment.

2. Subsequent Events Do Not Eliminate Unconstitutionality.

In 1986, California enacted so-called water's edge legislation, effective for years 1988 and thereafter, permitting an election to use a method other than worldwide combined reporting. JA-696 to 745. Neither the United States nor its foreign trading partners saw the California legislation as a resolution of the unitary tax problem. JA-746; Ex. 37I at 64.

In 1993, the California Legislature amended its water's edge legislation for years beginning on or after January 1, 1994, but continued worldwide combined reporting as its basic method.

California contended below that the 1986 legislation "solved" all problems retrospectively so that no constitutional violation existed. *See* Appellant Board's Opening Brief (California Supreme Court) at 37. Prospective legislation cannot cure past unconstitutionalities, (*see Dennis v. Higgins,* 498 U.S. 439, 448 (1991); *McKesson Corp. v. Division of Alcoholic Beverages and Tobacco,* 496 U.S. 18, 44 (1990)), nor for that matter can a single state adopt its own resolution to a national problem. *Japan Line,* 441 U.S. at 457.

The 1993 California amendments are not before this Court, but Barclays would disagree with any suggestion that these are a resolution. The new legislation does not comport with the international standard and continues disparate treatment, both facially and in effect, for those who elect. Recent cases of this Court suggest that such burdens are significant and are unconstitutional. *See, e.g. Allied-Signal, Inc. v. Director, Div. of Taxation,* 112 S. Ct. 2251 (1992); *Kraft Gen. Foods, Inc. v. Iowa Dep't of Revenue & Fin.*, 112 S.Ct. 2365.

In any event, prospective legislation cannot cure over 20 years of unconstitutionality.

II. WORLDWIDE COMBINED REPORTING INTRUDES INTO AN INHERENTLY FEDERAL AREA. IT IS PRE-EMPTED BY THE UNITED STATES CONSTITUTION.

The Constitution assigns no role to the states in the conduct of foreign policy:

> Governmental power over internal affairs is distributed between the national government and the several states. Governmental power over external affairs is not distributed, but is vested exclusively in the national government.

United States v. Belmont, 301 U.S. 324, 330 (1937). Where state legislation or action interferes with the conduct of foreign affairs by the Federal Government, the Constitution itself preempts it. *Zschernig v. Miller,* 389 U.S. 429. This is true even when the state legislation or action is in an area which states have traditionally regulated. *Id.* at 440.

In *Zschernig*, this Court set forth the test for this type of preemption: state legislation must fall where it has "a direct impact on foreign relations and may well adversely affect the power of the central government to deal with those problems." *Id.* at 441. In that case, the Court held that an Oregon statute that denied nonresident aliens inheritance rights in certain circumstances was unconstitutional because:

> [I]t has more than "some incidental or indirect effect in foreign countries," and its great potential for disruption or embarrassment makes us hesitate to place it in the category of a diplomatic bagatelle.

Id. at 434-35. The Court later noted that:

> The Oregon law does, indeed, illustrate the dangers which are involved if each State, speaking through its probate courts, is permitted to establish its own foreign policy.

Id. at 441.

The record in this case demonstrates that the use of worldwide combined reporting in these circumstances has had a direct impact on foreign relations and has interfered with federal conduct of foreign policy. *See* PA A-23 to 25; JA-575 to 79, 600 to 03. *See also* PA B-32, 53 to 54. The California method conflicts with the established international standard to which the United States and other nations of the world adhere, and the resultant disruption and embarrassment to the United States (as a leader in the development of the standard) are well documented. The United States' embarrassment was even greater because the Executive, charged with the negotiation of foreign policy, felt that the complaints were justified. JA-576, 774 to 78, 780-81.

Further, there can be no greater "disruption" to foreign policy than foreign retaliation, the ultimate result of state interference. This Court has expressed in case after case its concern that state interference in the sensitive area of external relations can lead to retaliation which will harm the Nation as a whole. *See Zschernig*, 389 U.S. at 440-41; *Hines v. Davidowitz*, 312 U.S. 52; *The Chinese Exclusion Case*, 130 U.S. 581 (1889); *Chy Lung v. Freeman*, 92 U.S. 275; *Henderson v. Mayor of New York*, 92 U.S. 259. Because of this threat, foreign policy must remain the prerogative of the central government, not of the states.

III. WORLDWIDE COMBINED REPORTING IMPOSES DISCRIMINATORY COMPLIANCE BURDENS ON FOREIGN COMMERCE.

One of the aspects of worldwide combined reporting which has offended foreign nations, and interfered with the conduct of this country's foreign relations, is the prohibitive administrative burden imposed on foreign multinationals by California's system. *See*

supra Part I, section B. As the courts below found, this compliance burden is greater than for domestic corporations. This discriminatory impact on foreign commerce in and of itself violates the foreign Commerce Clause, under the antidiscrimination component of this Court's Commerce Clause test.

A. California's Compliance System Discriminates Against Foreign Multinationals.

The courts below found that the compliance burdens imposed on foreign taxpayers by California's worldwide combined reporting system are significant and greater than those incurred by domestic taxpayers. PA D-9. Indeed, in its first opinion the California Court of Appeal, agreeing with the trial court's assessment of these costs as "prohibitive",[13] characterized the compliance requirements of worldwide combined reporting as an "administrative nightmare" for the foreign taxpayer. PA B-25. This nightmare arises from the fact that, solely to file a California tax return, the foreign taxpayer is forced to convert its diverse financial and accounting records from around the world into the language, currency, and accounting principles of the United States. PA A-26 to 27; PA B-25; JA-50 to 57, 66 to 67, 804 to 05; Ex. 37D at 4-7; R 1162-65, 1173-75. This prohibitively expensive process is not required by the arm's length method: under the international standard, Barclays would report to California only its business activities in the United States, the records for which are already available in English, the dollar currency, and United States accounting principles. JA-795, 800, 804 to 05.

[13] The trial court found that the cost to set up and maintain a system was "huge, over $5,000,000.00 to establish and over $2,000,000.00 annually to maintain." PA A-27 to 28; *see also* JA-58 to 65, 754, 809 to 10. Thus, the cost of compliance in the first year would have been greater than the amount of California income and many times greater than Barclays' total tax for 1977, as calculated by California. PA A-38 to 39. This is a constitutionally significant consideration. *Toomer v. Witsell*, 334 U.S. 385, 396-39 (1948); *Bibb v. Navajo Freight Lines, Inc.*, 359 U.S. 520, 527-28 (1959); *Raymond Motor Transport, Inc. v. Rice*, 434 U.S. 429, 445-47 (1978).

Domestic-based multinationals already keep most of their records in English, in United States currency, and in accord with United States accounting principles. PA D-9. They incur significantly lower administrative costs to comply with California's worldwide combined reporting system, and in doing business abroad do not have to create a second and separate system to report their worldwide operations to another country. PA A-28; JA-801 to 02, 804, 811-12. Accordingly, the compliance burdens of worldwide combined reporting are not an inherent cost of doing business in a foreign land. All nations, including the United States, observe the international practice and do not require inquiry beyond the operations of the entity in their respective countries.

B. Presumed Facial Neutrality Will Not Save a State Tax from Unconstitutionality Where There Is Discrimination in Effect.

Notwithstanding these prohibitive and discriminatory compliance burdens on foreign multinationals, the lower court determined that such compliance burdens were not unconstitutional because California asked for the same information from and applied the same tax rate to all taxpayers. PA D-10.

A burden upon commerce imposed by a state will not be sustained merely because the state enactment on its face applies the same terms to the people of all states, including the state enacting the requirement.[14] *Fort Gratiot Sanitary Landfill, Inc. v. Michigan Dep't of Natural Resources*, 112 S. Ct. 2019, 2025

[14] The California court's attempt to justify the discrimination against foreign multinationals, by asserting that the cost to create and maintain a California compliance system for domestic multinationals is also prohibitive, misses the mark. If anything, this conclusion supports a holding of discrimination against all foreign commerce, whether part of a domestic or a foreign multinational's operations. In any event, the Court of Appeal itself acknowledged that there is an *additional* compliance burden on foreign multinationals. That difference is constitutionally significant. *Maryland v. Louisiana*, 451 U.S. 725, 756-60 (1981); JA-801 to 02. *See also Kraft Gen. Foods Inc. v. Iowa Dep't of Revenue & Fin.*, 112 S. Ct. 2365.

(1992); *Brimmer v. Rebman*, 138 U.S. 78, 82 (1891). "Facial neutrality" is no protection. Under well-established authority of this Court, a state's power may not be used with the aim *or the effect* of discriminating against interstate or foreign commerce. *Hunt v. Washington State Apple Advertising Comm'n*, 432 U.S. 333 (1977); *Tyler Pipe Indus., Inc. v. Washington State Dep't of Revenue*, 483 U.S. 232 (1987); *Nippert v. City of Richmond*, 327 U.S. 416 (1946).

Here, the discriminatory effect — and its unconstitutionality — are clear. This Court's decision in *Hunt* is instructive. In *Hunt*, this Court held that a North Carolina provision, barring all grades other than USDA on sales of apples in closed containers, had the *practical* effect not only of burdening interstate sales of Washington apples, but also of discriminating against them. The discriminatory provision raised the costs of doing business in the North Carolina market for Washington apple growers and dealers, while leaving those of their North Carolina counterparts unaffected. This Court pointed out: "the increased costs imposed by the statute would tend to shield the local apple industry from the competition of Washington apple growers and dealers who are already at a competitive disadvantage because of their great distance from the North Carolina market." 432 U.S. at 351.

Here, California's compliance requirements clearly raise the cost of doing business in the California market for foreign multinationals, and — indeed — to a "prohibitive" level. PA A-27; JA-803, 805-06. Domestic multinationals incur lesser burdens in California and do not incur the incremental costs of responding to an entirely different set of worldwide information requirements when they do business abroad. Domestic multinationals also retain the economic benefits of the compliance systems they have established under the international standard. As in *Hunt*, this discriminatory impact constitutes a competitive disadvantage for foreign multinationals, and a preference in favor of domestic interests. This "economic protectionism," PA A-28, plainly is unconstitutional.

C. Filing a California Tax Return on the Basis of "Reasonable Approximations" Increases, Not Eliminates, Discrimination.

Contrary to the Court of Appeal's conclusion, PA D-15 to 16, 19, this unconstitutional discrimination is not cured by the discretionary relief provision of California's worldwide filing regulation. The purpose of California Code of Regulations, Title 18 § 25137-6 (PA J) (the "Regulation") is to convert financial information of a multinational unitary business to California tax reporting standards. The court below agreed that no foreign multinational could comply with this Regulation without prohibitive cost but concluded that the foreign taxpayer could avoid cost by using "reasonable approximations" under the discretionary relief provision of subdivision (e).

Such a system is unworkable and uncertain,[15] JA A-798, 805 to 09, but, apart from that, the relief provision itself creates further discrimination. JA-794 to 95, 806 to 09. As the trial court found, and the Court of Appeal did not deny, to obtain certain tax benefits under California law (*e.g.*, California tax depreciation) foreign multinationals must produce information or schedules for their worldwide operations in accord with the California tax principles. PA A-27; JA-788 to 791, 806 to 08. *See also* JA-794 to 95.

The "practical effect" of California's compliance requirements is that foreign multinationals are left to file their tax returns on the basis of consolidated financial statements and regulatory reports.[16] Tax accounting and financial accounting are admittedly different; one does not and should not normally use the account-

[15] The Court of Appeal sanctions wholesale non-compliance with the Regulation. Since foreign multinationals can not comply with the mandatory provisions of the Regulation (i.e. "literal compliance"), all must file by approximation and thereafter negotiate their tax liability. This results in a system of court sanctioned "taxation by negotiation" — a due process violation. *See infra* Part IV.

[16] If California does not accept such approximations the penalty to the foreign taxpayer is "terribly onerous": it must produce the underlying records and file in accordance with "the literal requirements" of the

ing appropriate to an annual shareholder's report to prepare and file an income tax return, in California or elsewhere. PA A-26; JA 801 to 02. As a consequence, the income on which foreign multinationals pay tax is different (and typically greater) than that for domestic multinationals.[17] JA-788 to 91.

Accordingly, whether the discrimination takes the form of prohibitive compliance burdens or lost tax benefits or both, it violates the antidiscrimination component of this Court's basic Commerce Clause test.

IV. CALIFORNIA'S TAX FILING REGULATION VIOLATES DUE PROCESS.

A foreign multinational cannot, without inordinate cost, file a California tax return in accordance with the "mandatory" provisions of Regulation 25137-6 (*i.e.*, subdivisions (a) through (d), PA J-1 to 8). D-19. Such a multinational must rely on acceptance by California, under subdivision (e) of its Regulation, of information in lieu of that which is required. JA-840 to 43. When every foreign multinational must rely on the discretion of the taxing authority to file its tax return, discretion itself becomes the system. JA-860. The California trial court found that this constituted taxation by "supplication and negotiation" and a due process violation. PA A-29.

This Court requires that a statute or regulation contain sufficiently explicit standards, not only to permit a person of ordinary intelligence to understand what conduct is prohibited, but also to prevent arbitrary, harsh and discriminatory enforcement by government officials. *Grayned v. City of Rockford*, 408 U.S. 104, 108 (1972); *Kolender v. Lawson*, 461 U.S. 352, 360 (1982); *Papachristou v. City of Jacksonville*, 405 U.S. 156, 162, 168-169

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regulation. JA-804. California's own expert agreed filing under the literal requirements was unreasonable. *Id.*

[17] To further compound the problem, there are differences in tax effect when a foreign multinational must convert worldwide information to U.S. accounting standards and the dollar currency. *See* Roy E. Crawford, *Currency Exchange Problems in California's Worldwide Unitary Taxation*, 40 Bull. for Int'l Fiscal Documentation 378, 378-79 (1986).

(1972). A court may interpret the language of a regulation to determine whether it contains the necessary standards for due process purposes, but the provision so interpreted must itself pass constitutional muster. *See Kolender*, 461 U.S. at 358.

The California court asserted that no due process violation occurs here because the judiciary can ostensibly judge the reasonableness of California's exercise of discretion by weighing cost to develop information against a taxpayer's profferred approximations. *But see* JA A-807 to 08. The California court's interpretation of the regulation does not solve its constitutional infirmities.

The grant of standardless discretion itself violates due process; a taxpayer need not suffer actual harm from arbitrary application. *Chy Lung v. Freeman*, 92 U.S. 275; *Yick Wo v. Hopkins*, 118 U.S. 356 (1886). Foreign multinationals remain at peril in filing their tax returns because there is no standard to determine what "approximations" will be accepted.[18] JA-860. Information accepted varies from year to year and from auditor to auditor. JA A-805 to 09. It is difficult if not impossible for a taxpayer to establish a compliance system given this uncertainty. *See* JA-794 to 95, 798.

Filing on approximations also means not only that the foreign multinational loses tax benefits, but also that it pays tax on a different measure of income than do its domestic competitors. *See* Part III *supra*. Discrimination in effect is not an answer to California's standardless and arbitrary "relief" provision. In this sensitive area affecting foreign relations, a system of taxation by discretion cannot stand. *Kraft Gen. Foods, Inc. v. Iowa Dep't of Revenue and Fin.*, 112 S. Ct. at 2365; *Chy Lung v. Freeman*, 92 U.S. at 275.

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[18] The California court seems to equate "approximations" with financial information. Since the purpose of the Regulation is to *convert* financial information, the taxpayer is still left with uncertainty as to what or how much is acceptable. The other "relief" provisions have similar vices. *See* JA-805 to 09. Failure to guess correctly can result in penalties. *See* PA B-27.

CONCLUSION

No state tax issue in recent memory has created the international furor of worldwide combined reporting. For all the reasons stated herein, the application of this method in these circumstances is clearly unconstitutional.

Respectfully submitted,

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APPENDIX

APPENDIX I

RULE 29.1 LIST
BARCLAYS' LESS THAN 100% OWNED SUBSIDIARIES

Subsidiary	Ownership Interest
Europe Asia Dynamic Fund Management Co. SA ..	70.00%
Massey-Ferguson Leasing Ltd.	75.00%
NB Geotech Finance Ltd.	51.00%
Fiatagri Finance Ltd.	51.00%
Barmac (Estates) Ltd.	50.10%
Blocksite Ltd.	50.20%
Bramingham Park Ltd.	50.10%
Chadacre Developments Ltd.	50.10%
Charmtape Ltd.	50.10%
Growlimit Ltd.	50.10%
J.V. Developments Ltd.	50.10%
Loopbeam Ltd.	50.10%
Mervest (Hendon) Ltd.	70.00%
Mervest (Sloane) Ltd.	51.00%
PSA Credit Company Ltd.	50.01%
Regmore Developments Ltd.	50.20%
Regmore Homes Ltd.	50.10%
Royco Business Parks Ltd.	50.10%
Wates-Barclays-Mercantile Homes Ltd.	50.01%
Wadham Stringer Credit Company Ltd.	75.00%
Barclays Motor Finance Ltd.	75.00%
Barclays Motor Wholesale Pty. Ltd.	75.00%
Barclays Bank of Botswana Ltd.	74.86%
Barclays Pensions Management Consultants (Pty.) Ltd.	74.86%
Barclays Bail SA	99.99%
Barclays Gestion SA	99.99%

Subsidiary	Ownership Interest
Barclays Immobilier SARL	99.95%
Barclays Invest Ltd.	99.99%
Barclaymur SA	99.99%
Financiere Laffitte	99.99%
Laffitte Capital	99.99%
Laffitte Patrimoine	99.99%
Laffitte Gastion	99.80%
Laffitte Investissement	99.99%
Laffitte Securities SA	99.99%
S.A.G.O.	99.99%
S.C. Des Garages du 21 Rue Laffitte	57.50%
Lutetia Societe Financiere SA	99.94%
Soc de credit Pour acquistion et amelioration des Immeubles	99.98%
S.F.G.C. (Group Barclays)	99.99%
Immogestion Barclays SA	99.90%
Society Civile Immobiliere Barclays IMMO-Hexagone	99.93%
Barclays Bank Botswana Nominees (Pty) Ltd.	74.86%
Barclays Bank of Ghana Ltd.	60.00%
Barclays Bank of Ghana Forex Bureau Ltd.	60.00%
Barclays Bank of Kenya Ltd.	68.50%
Barclays Advisory and Services Ltd.	68.50%
Barclays (Kenya) Nominees Ltd.	68.50%
Barclays Merchant Finance Ltd.	68.50%
Eagle Training Centre (Pty) Ltd.	74.86%
Spread Eagle Services Limited	68.50%
Barclays Bank of Serra Leone Ltd.	60.00%
Barclays Bank SA	99.44%
BARGES SA	99.44%
Ruval SA	99.44%

Subsidiary	Ownership Interest
Segunda Banlid de Inversion Immobiliaria SA (SEBANSA)	99.44%
Barclays Entidad De Financiacione, SA	99.44%
Serteban SL	99.44%
Barclays Correduria de Seguros SA	99.44%
Barclays Bank of Swaziland Ltd.	60.00%
Barclays Bank of Uganda Ltd.	51.00%
Barclays Bank of Uganda (Foreign Exchange Bureau) Ltd.	51.00%
Barclays Bank of New York, NA[1]	99.90%
Barclays Bank of Zimbabwe Ltd.	70.00%
Barclays Vie S.A.	99.99%
Barclays Zimbabwe Nominees (Pvt) Ltd.	70.00%
Barclaytrust (Pvt) Ltd.	70.00%
Claydon Holdings, Inc.	95.00%
Claydon Properties, Inc.	95.00%

[1] Barclays Bank of New York, N.A. has a number of 100 percent owned subsidiaries, not listed here.

(43)

No. 92-1384

In The

Supreme Court of the United States

October Term, 1993

BARCLAYS BANK PLC,

Petitioner,

v.

FRANCHISE TAX BOARD, An Agency of the State of California,

Respondent.

On Writ Of Certiorari To The Court Of Appeal Of The State Of California In And For The Third Appellate District

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BRIEF FOR RESPONDENT

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QUESTIONS PRESENTED

1. Whether the California Supreme Court properly declined to apply a dormant Commerce Clause analysis and properly held that, due to congressional acquiescence, California did not violate the Foreign Commerce Clause by application of worldwide combined reporting to determine the taxable California income of the Barclays taxpayers.

2. If a dormant Commerce Clause analysis were appropriate, would California's use of worldwide combined reporting violate the discrimination element of such a dormant analysis even though California applied the same tax and reporting requirements upon all taxpayers, whether their multinational group was headed by a foreign or a domestic parent corporation?

3. Even though California's practice is held to be valid under the Foreign Commerce Clause, whether California's application of worldwide combined reporting to the Barclays taxpayers is nevertheless preempted by the United States Constitution as an intrusion into an inherently federal area; specifically, whether the Executive Branch's foreign affairs powers can eclipse Congress' exercise of its treaty and Commerce Clause powers to permit such state use of worldwide combined reporting.

4. Whether California's tax reporting procedures, which permit taxpayers to avoid high compliance expenses through the use of reasonable approximations, and which provide for court review of any claimed abuse of administrative discretion, deny taxpayers due process of law.

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No. 92-1384

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BRIEF FOR RESPONDENT

SUPPLEMENTAL STATEMENT OF THE CASE

This case presents a constitutional law challenge to California's application of worldwide combined reporting ("WWCR"). Under WWCR, formula apportionment is applied to the combined net income of a multinational and multicorporate unitary business in order to determine the net income earned in California by a specific corporation. The three-factor formula used in WWCR, and the arm's length/separate accounting ("AL/SA") alternative which Barclays is asking this Court to impose upon California, are described in detail

by the California Supreme Court in its opinion. PA C-4 to C-5.[1]

A hybrid of WWCR and AL/SA, called the "water's edge" approach, allows both foreign-based and domestic-based unitary businesses to choose to confine application of WWCR to United States incorporated entities and, only in limited circumstances, to some portion or all of foreign incorporated entities. See PA C-35. Since at least 1984, the federal Executive Branch has been encouraging the voluntary adoption of water's edge legislation by the WWCR states. Exs. 29, 371. No state any longer requires full WWCR application to all multinational unitary groups. California adopted its first water's edge legislation in 1986 (JA A-696 through A-745); this legislation was amended in 1993. See Bd.'s Supp. Br. in Opp. The Solicitor General has reported to this Court that those amendments "have brought that State's law into acceptable harmony with federal and international 'arm's length' tax practice." October 1993 Brief for United States as Amicus Curiae, p. 10.

In this case, involving income year 1977 for franchise tax year 1978, WWCR was used to determine the California net income of two taxpayers, Barclays Bank International, Inc. ("BBI"), incorporated in England, and Barclays Bank of California ("Barcal"), incorporated in California (referred to together as the "Barclays taxpayers"). JA A-9 through A-14.[2]

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[1] In this brief respondent Franchise Tax Board (the "Board") has adopted the same record citation abbreviations detailed by petitioner Barclays on page one of the Brief for Petitioner (which will be cited herein as "Br.Pet.").

[2] Due to subsequent corporate mergers and sales, the tax claims of the Barclays taxpayers are now being pursued in this Court by petitioner Barclays Bank PLC ("Barclays"). Br.Pet. ii. The amounts directly at issue in this case for the Barclays taxpayers are relatively small: $1,678 additional tax (12 percent more than reported) assessed to BBI, and $152,420 additional tax (28 percent more than reported) assessed to Barcal. JA A-13 to A-14. As Barclays has pointed out to this Court in its earlier supplemental brief (p. 1), this case as a precedent has approximately $1 billion in California tax revenues at stake. When the *Barclays* and *Colgate-Palmolive Co.* v. *Franchise Tax Bd.* ("*Colgate*"), No. 92-1839, cases are considered together, more than $4 billion ultimately is at risk. Br.Pet. in *Colgate*, p. 38.

Key facts are undisputed. The two Barclays taxpayers, Barcal and BBI, have stipulated: (1) that they did business in California and were members of a worldwide unitary business composed of the members of the Barclays Group, headed by Barclays Bank Limited ("BBL") (JA A-9 to A-11, A-16); (2) that they are not contending in this case that the three-factor apportionment formula used by the Board is unfair, nor are they contending that any distortion resulted from the Board's application of the unitary method in this case (JA A-832 to A-833);[3] and (3) that they have withdrawn from this case any issue as to whether application of WWCR violates the nondiscrimination clauses of United States income tax treaties (R 1815-24).

Much of petitioner Barclays' statement regarding the case consists of arguments dressed as facts.[4] However, these are sins of argumentative excess rather than instances of direct "inaccuracy or omission" under rule 24.2. To counter all such statements in this Supplemental Statement of the

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[3] This stipulation resulted in the trial court's refusing to permit the Board to present any evidence solely to establish the fairness of California's formula and the lack of significant distortion (R 1549-1554). Despite this stipulation, the Brief for Petitioner is larded with arguments dependent upon perceptions that California's formula led to an unfair result, with extraterritorial taxation resulting from distortion. See, *e.g.*, Br.Pet. 5, 7, 16, 24, 25. Although Barclays usually tries to circumvent its fundamental and limiting stipulation by attributing these perceptions to others, there can be no question that overall, and contrary to the stipulation, the Brief for Petitioner rests substantially upon unproven allegations of unfair apportionment and formulary distortion.

[4] Note the argumentative types of sources which Barclays cites for support throughout its statement of the case. For example, Barclays cites several sources to support its contention that California's WWCR method of tax accounting is "incompatible" with AL/SA. Br.Pet. 5. The source which uses the word "incompatible" is an advocacy statement ("United Kingdom Versus Unitary Taxation") made to the United States Treasury Working Group on Worldwide Unitary Taxation on behalf of the United Kingdom. JA A-68, A-70. Clearly this Court is not bound by the argumentative characterization of California's tax by the government which has refused to recognize the validity of this Court's own 1983 evaluation of WWCR and AL/SA. Notice should also be taken of Barclays' repeated and extensive reliance on the first opinion of the California Court of Appeal (see, *e.g.*, Br.Pet. 25, 26, 44). This is the opinion which (under California rule of court 976) was superseded by the California Supreme Court's granting of review and which was reversed by the California Supreme Court on the merits.

Case would leave no room for the Board's argument. Therefore, confident that the Court can distinguish a fact from an argument, the Franchise Tax Board will counter the Barclays "fact" arguments in the argument sections of this brief. For a more neutral presentation of the facts surrounding this case, reference can be made to the California Supreme Court's statement (PA C-2, C-4 through C-13, C-27 through C-31, C-33 through C-37) of the factual, procedural, legislative and case law background, which is included herein by reference.[5]

SUMMARY OF ARGUMENT

When presented to the Senate for ratification in 1976, the United States/United Kingdom income tax treaty ("US/UK Treaty") contained an explicit ban on the states' use of worldwide combined reporting (WWCR). That proposed ban was the subject of intense and prolonged Senate debate. Ultimately, the treaty could achieve Senate approval only when conditioned on the removal of that prohibition, thus indicating continued permission for the states to use WWCR.

In this case the fiscal security of the State of California is threatened because California has imposed just the sort of state tax that the ratified version of the US/UK Treaty permits. Is congressional permission for California to apply WWCR to foreign commerce eclipsed by a later presidential press release, or by a letter from the Secretary of State which asks the Governor of California to seek legislative changes? Can that congressional permission be erased by United Kingdom threats of retaliation which would be a direct violation of that treaty? If so, there has been a major shift in the points of balance which the United States Constitution provides between the Legislative and Executive Branches, and between the national and state governments.

[5] Facts involving the following subjects are found below as indicated: negotiation and ratification of the US/UK Treaty – pp. 20-22; bilateral income tax treaties and Friendship, Commerce and Navigation treaties – pp. 15-18; Executive Branch actions which acknowledge congressional acquiescence in the states' use of WWCR – pp. 25-27; the Barclays taxpayers' costs of compliance with California WWCR – pp. 40-41; California water's edge election legislation – pp. 30-31.

If Congress has acquiesced in the states' use of WWCR, California's use of WWCR cannot violate the Commerce Clause – the Constitution gives Congress the power to regulate foreign commerce. The Constitution also protects the interests of the states by requiring that any treaty must be approved by at least two-thirds of the senators present. Both of these constitutional provisions have important roles in determining the outcome of the Commerce Clause issue presented by this case.

Almost all United States income tax treaties restrict the federal government from engaging in WWCR, and most such treaties restrict the states in some aspects of corporate income taxation; however, no treaty restricts the states' use of WWCR. In 1975 the United Kingdom sought to break from this established pattern by negotiating the insertion into the US/UK Treaty of a ban on state use of WWCR. That ban could not and did not survive Senate review of the negotiated treaty. There was only one way the US/UK income tax treaty could obtain the required two-thirds approval in the Senate: through the Senate's attachment of a reservation "declining to give its consent to a provision in the treaty that would have extended the restriction against [WWCR] apportionment taxation to the States." (*Container Corporation* v. *Franchise Tax Board*, 463 U.S. 159, 196 (1983) (hereinafter "*Container*"). The congressional record of Senate debates on the US/UK Treaty explicitly documents (1) the intense congressional focus upon the WWCR foreign commerce issues and (2) the ultimate decision to permit the states' use of WWCR by removing the explicit ban on such use which otherwise would have been part of the final treaty.

Short of explicit permission in the language of the treaty itself, there could be no clearer indication of Senate acquiescence in the use of WWCR by California and other states. Unless California must show such an explicit statement in the law itself, that acquiescence makes California's use of WWCR immune from all Commerce Clause attack.

No explicit permission need be found in the terms of the treaty. The clear congressional record regarding the Senate's removal of the state WWCR ban from the US/UK Treaty

provides considerably more documentation of congressional permission than precedent requires. The final terms of the US/UK Treaty are consistent with all other United States income tax treaties, and such terms by themselves fully establish congressional acquiescence by implication. Under *Wardair Canada, Inc.* v. *Florida Dept. of Revenue*, 477 U.S. 1 (1986) ("*Wardair*"), and *Itel Containers International Corp.* v. *Huddleston*, 113 S.Ct. 1095 (1993), the treaty provisions alone, by barring the national government from using WWCR while at the same time restricting state income-based taxes in some respects but not as to WWCR, establish congressional awareness of the WWCR issue and congressional intent to permit state use of WWCR.[6] The special and compelling facts of the US/UK Treaty's negotiation and ratification history merely confirm beyond doubt the implication which can be found in the treaty provisions themselves.

Since there has been authoritative congressional action which permits California's use of WWCR in the foreign commerce context, the Commerce Clause is not dormant here. There is no need for any dormant Commerce Clause analysis. Even if the California tax were guilty of all the sins imputed to it by Barclays or Barclays' *amici* – even if it imposed unfair apportionment, gave rise to justifiable foreign retaliation, created automatic asymmetry with inevitable multiple taxation, and discriminated on its face against foreign companies – Congress' actions permitting California's use of WWCR would preclude possibility of any *Commerce Clause* violation.

In any event, even though any dormant Commerce Clause analysis would be totally superfluous in this case, if such an analysis were applied here it would establish that California's use of WWCR led to none of these purported consequences.

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6 While this Court in *Container* considered whether Congress had ever issued a clear federal directive preempting the states' use of WWCR, the *Container* opinion did not consider whether Congress had ever acted to permit the use of WWCR by the states.

California's application of WWCR results in fair apportionment of income. In *Container*, which involved a domestic-based multinational business, this Court held that California's version of WWCR was a fair and proper method of taxation, with income apportionment which did not operate unconstitutionally to tax extraterritorial values. There is no basis for reaching a different conclusion when, as here, a foreign-based multinational business is involved. The Barclays taxpayers conceded this point by stipulating at trial to remove the issue of unfair apportionment and distortion from this case.

Since in *Container* this Court has resolved that California's use of WWCR is a fair and proper means of income apportionment, under a "one voice" dormant Commerce Clause analysis no foreign retaliation can be justified on the misconception (shared by many of Barclays' *amici*) that WWCR is unfair, improper and distortive. Also, the record shows that Congress has long had the state WWCR issue before it, including foreign contentions such as distortion and unfair compliance burdens, and with that awareness Congress has taken no action to preempt state use of WWCR. Clearly, Congress does not consider this "an area where federal uniformity is essential" (*Container* at 193), or Congress would have enacted one of the bills (or would have ratified the US/UK treaty as initially negotiated) which would have required just such uniformity. Therefore California's use of WWCR has not prevented the federal government from speaking with one voice in international trade. Furthermore, the federal Executive Branch, after more than a decade of working for cooperative harmonization of the states' tax prerogatives with the Executive Branch's foreign policy concerns, has solved the problem to its satisfaction and has finally certified to this Court that California's law now is in acceptable harmony with international practices. Under these present circumstances, this Court should not be drawn into the political arena of "one voice" foreign policy speculations.

California's use of WWCR does not result in unconstitutional multiple taxation. The actual *Container* holding as to multiple taxation was based on one determination: while

multiple taxation of income might be presumed to result from California's application of WWCR, equivalent or greater multiple taxation might result from requiring California to engage in some form of arm's length separate accounting. This holding is not dependent upon the nationality of the taxpayer's ultimate parent. Whether the unitary business is domestic-based or foreign-based, California's application of WWCR to tax the California parts of a multinational business does not result in an unconstitutionally enhanced risk of multiple taxation.

There could be no violation of the discrimination element of a dormant Commerce Clause analysis. California's tax does not differentiate between members of domestic-based and foreign-based multinational businesses; the same tax and reporting requirements are imposed upon all businesses by California law. Contrary to Barclays' position, California's law cannot become unconstitutionally discriminatory because *federal* tax law imposes different reporting burdens for federal tax returns.

A determination that California's use of WWCR is valid under the Commerce Clause necessarily means that the tax cannot be invalidated on "foreign affairs" grounds. Either Congress, in full control of foreign commerce, has given permission (which is binding on the Executive Branch), or a dormant Foreign Commerce Clause analysis has already included a balancing and determination of foreign affairs issues in reaching the holding which validates the tax.

California applies WWCR in a manner which fully satisfies the requirements of due process. Compliance with WWCR accounting can be achieved at a very moderate cost through the use of reasonable approximations, as permitted by the California regulation's terms. "Reasonableness" is a fully meaningful standard which is often used in due process jurisprudence. The California courts have determined that California law provides for full court review of the Franchise Tax Board's discretionary determinations of what approximations are reasonable.

ARGUMENT

I. INTRODUCTION: *CONTAINER* AND THIS COURT'S ESTABLISHED RECOGNITION OF THE MERITS OF FORMULARY APPORTIONMENT.

This case is a natural outgrowth of this Court's 1983 decision in *Container*. It is therefore necessary to be clear at the outset about key conclusions which this Court has already reached in *Container*:

1. Due Process Clause and Commerce Clause nexus is established for purposes of applying WWCR whenever some part of the unitary business is conducted in the taxing state. 463 U.S. at 165-66.

2. WWCR's use of formula apportionment of income does not result in taxation of non-California corporations or in taxation of non-California income; it is only a means of determining what portion of the unitary income can be fairly attributed to the part of the unitary business that actually is being conducted in California. 463 U.S. at 164-65, 184, 192.

3. The three-factor formula used by California in applying WWCR has become something of a benchmark against which other apportionment formulas are judged, because property, payroll and sales appear in combination to reflect a very large share of the activities by which value is generated. 463 U.S. at 170, 183.

4. WWCR is a proper and fair method of taxation which reflects a reasonable sense of how income is generated, and which avoids the basic theoretical weaknesses of AL/SA. 463 U.S. at 169-70, 181, 184.

5. Separate accounting is subject to manipulation and imprecision, and often ignores or captures inadequately the many subtle and largely unquantifiable transfers of value that take place among the components of a single worldwide enterprise. 463 U.S. at 164-65.

6. When considering distortion contentions which compare WWCR results with profit or loss determinations made under AL/SA, one must keep in mind it is the basic theoretical weaknesses of AL/SA which justify resort to formula apportionment in the first place. 463 U.S. at 181-82.

7. While actual double taxation was assumed to exist in the *Container* context (463 U.S. at 187 & n. 22), there was no enhanced risk of double taxation violative of dormant Foreign Commerce Clause analysis. Although AL/SA is used by the federal tax authorities and foreign governments, California's use of WWCR does not result in inevitable multiple taxation. California's switch to any particular AL/SA method might only increase a taxpayer's risk of multiple taxation, because of the substantial lack of uniformity in the ways the various nations apply AL/SA.[7] Under these circumstances it would be perverse to require California to give up one allocation method (WWCR) which sometimes results in double taxation in favor of another allocation method (AL/SA) which also sometimes results in multiple taxation. 463 U.S. at 163, 184, 191, 192-93.

8. When *Container* was decided in 1983, no clear federal directive prohibited state use of WWCR. When determining whether such a clear federal directive exists, the Court looks to specific indications of congressional intent. No such preemptive intent shall be drawn from treaty restrictions which are placed solely upon the national governments. 463 U.S. at 196-97.[8]

[7] The lack of uniformity which exists between the United States and the United Kingdom AL/SA rules is dramatically illustrated in this case by BBI's comparison, for United Kingdom double tax relief purposes, between BBI's United States income as computed under U.S. AL/SA and U.K. AL/SA. Using United States AL/SA procedures, BBI showed a very substantial loss for the year ended September 30, 1977. Under United Kingdom AL/SA, the same United States operations were shown as generating a large profit for the same period. Ex. 51J. The immense difference arises because the AL/SA rules of the United States and the United Kingdom are different.

[8] This preemption analysis was the only *non*-dormant Commerce Clause analysis in *Container*. When dealing with the question of the "one voice" of the federal government in foreign commerce, *Container* only considered whether California's application of WWCR *violated* either one of two branches of the one voice standard, indicating that the state tax "will violate the 'one voice' standard if it *either* implicates foreign policy issues which must be left to the Federal Government [the dormant clause branch of the standard] *or* violates a clear federal directive." 463 U.S. at 194 (emphasis by the Court). Thus the only non-dormant Foreign Commerce Clause analysis in *Container* was a consideration whether the one voice had spoken to *preempt* California's use of WWCR. *Id.* In the words of the *Barclays* trial court, *Container* "did not address the question of whether such policy was expressed Congressionally *for* it." PA A-31 (emphasis by the court). *Container*'s consideration of "specific indications of congressional intent" (463 U.S. at 196) was restricted to the preemption analysis, with this Court deciding that "we cannot conclude that the California tax at issue here is preempted by federal law. . . . " *Id.* at 197. Since the *Container* Court did not even consider whether the federal government's one voice had spoken to *permit* California's use of WWCR, no *Container* holding is contradicted when the later *Wardair* analysis is applied in the present case to find such permission.

9. Absent some explicit directive from Congress, AL/SA treatment of income by federal tax authorities does not mandate uniform, identical treatment by the states. 463 U.S. at 194.

10. The possible implication of foreign affairs, which are more the province of the Executive Branch and Congress than of the courts, is included within the consideration of the "one voice" test of a dormant Foreign Commerce Clause analysis. 463 U.S. at 194-96.

11. In the application of the "one voice" test in a dormant Foreign Commerce Clause analysis, the most obvious foreign policy implication is whether the state tax might justifiably lead to significant foreign retaliation. The *Container* result indicates that the mere existence of a difference between the income allocation methods of a state and a foreign country does not provide grounds to justify foreign retaliation. 463 U.S. at 194-96.

Container was the culmination of a long history of this Court's recognition of the merits of the unitary method of apportioning income. As this Court stated in *Trinova Corp.* v. *Michigan Dept. of Treasury*, 498 U.S. 358, 378 (1991), "since *Underwood Typewriter Co.* v. *Chamberlain*, 254 U.S. 113 (1920), we have recognized the impracticability of assuming that all income can be assigned [by geographic designation] to a single source." And as stated by this Court in 1992, "The principal virtue of the unitary business principle of taxation is that it does a better job of accounting for 'the many subtle and largely unquantifiable transfers of value that take place

among the components of a single enterprise' than, for example, geographical or transactional accounting." *Allied-Signal, Inc.* v. *Director, Div. of Taxation*, ___ U.S. ___, 112 S.Ct. 2251, 2261 (1992).

II. THE CALIFORNIA SUPREME COURT CORRECTLY HAS APPLIED *WARDAIR* TO HOLD THAT, BECAUSE COMPELLING IMPLICATIONS OF CONGRESSIONAL ACQUIESCENCE ARE FOUND IN CONGRESSIONAL ACTIONS, CALIFORNIA'S USE OF WORLDWIDE COMBINED REPORTING IS VALID UNDER THE COMMERCE CLAUSE, WITH NO NEED FOR ANY DORMANT COMMERCE CLAUSE ANALYSIS.

A. Congress' Commerce Clause powers and this Court's *Wardair* decision.

The United States Constitution gives the power to regulate foreign and interstate commerce to *Congress*. U.S. Const. art. I, § 8(3); PA App. F. Thus, as to foreign or interstate commerce matters, congressional action prevails over any conflicting actions or desires of the Executive Branch. See *United States* v. *Curtiss-Wright Export Corp.*, 299 U.S. 304 (1936); *United States* v. *Guy W. Capps, Inc.*, 204 F.2d 655 (4th Cir. 1953), aff'd on other grounds, 348 U.S. 296 (1955). If Congress has exercised its commerce powers so as to permit state action there cannot possibly be any violation of the Commerce Clause. Once such permission is ascertained, "any action taken by a State within the scope of the congressional authorization is rendered invulnerable to Commerce Clause challenge." *Western & Southern L.I. Co.* v. *Bd. of Equalization*, 451 U.S. 648, 653 (1981); see also *Wardair*, 477 U.S. at 12-13. Given Congress' total power in regulating foreign and interstate commerce, in granting such permission Congress is unrestricted by any of the policy standards which would apply in a *dormant* Commerce Clause context.

In *Container* this Court upheld the constitutionality of California's worldwide combined reporting method as applied to a multinational unitary business with a domestic ultimate parent. This Court reserved the question of whether it would

reach the same result if (as in this case) the ultimate parent corporation were foreign. 463 U.S. at 193-97.[9]

Three years after *Container*, in *Wardair*, this Court provided the analytic tool which, as properly applied by the California Supreme Court to undisputed facts, mandates the resolution of *Container's* reserved question in favor of California's use of WWCR. Noting that a *dormant* Commerce Clause analysis need not be applied when federal law indicates an authoritative federal decision to *permit* the challenged state tax, this Court held in *Wardair* (consistent with such precedents as *South-Central Timber Dev.* v. *Wunnicke*, 467 U.S. 82, 91-92 (1984)) that, even when the law lacks an explicit statement of permission, such a permissive decision can exist by *implication*. *Wardair* requires that such implications are to be drawn from "the *law* as it presently stands," not from any "*aspiration*" for what the law might become. 477 U.S. at 10 (emphasis by the Court).

In *Wardair*, Florida imposed a tax on all aviation fuel sold within the state, and a Canadian airline challenged the application of Florida's tax to fuel used by foreign airlines exclusively in foreign commerce. On the Commerce Clause issue in *Wardair*,[10] the taxpayer and the Solicitor General as *amicus curiae* argued that the Florida tax unconstitutionally

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[9] Since this question specifically was reserved in *Container*, and since Barclays has never sought the overruling of *Container*, respondent Franchise Tax Board has not argued that any decision against the Board in *Barclays* should be applied prospectively only. The Board has argued and continues to argue strenuously that prospective-only application should be given to any adverse decision in *Colgate*, No. 92-1839, which involves exactly the same situation that was presented and resolved in favor of the Board in *Container*. For the reasons given in the Board's brief in *Colgate*, any decision in either *Barclays* or *Colgate* which is based upon the overruling of *Container* should be applied prospectively only.

[10] The *Wardair* Court also held that the Florida tax was not preempted by the Federal Aviation Act, but the Court explicitly stated that it did not rely on a permissive provision of that act "to answer the Commerce Clause issue" present in *Wardair*. 477 U.S. at 6-7. Barclays errs in implying (Br.Pet. 36) that the Federal Aviation Act served in any way as a basis for the *Wardair* Commerce Clause holding. *Amici* supporting Barclays compound this error by arguing that the Federal Aviation Act was "dispositive" in the *Wardair* Commerce Clause holding. See, *e.g.*, Brief for Keidanren, pp. 5-6.

interfered with the ability of the federal government to speak with one voice because there was a federal policy to exempt such fuel from tax. As evidence of the alleged federal "policy," Wardair and the Solicitor General principally relied on (1) the Chicago Convention on International Civil Aviation, an international treaty to which the United States and 156 other countries, including Canada, are parties; (2) a resolution adopted by the International Civil Aviation Organization ("ICAO") in 1966; and (3) more than 70 bilateral agreements into which the United States has entered with various countries dealing with international aviation.

Discussing each of these in turn, this Court pointed out: (1) that the terms of the Chicago Convention precluded the imposition of local taxes on fuel only when the fuel already is on board an arriving aircraft, thus raising a "negative implication" that there had been "a decision by the parties to that convention to address the problem of [state and local taxation] by curtailing and limiting only some of the localities' power to tax, while implicitly preserving other aspects of that authority" (*id.* at 10); (2) that the resolution adopted by the ICAO, while it endorses an international scheme of tax exemption, is merely the work product of an international organization of which the United States is a member and has no force of law (*id.* at 11); and (3) that while most of the 70 bilateral agreements commit the United States to refrain from imposing national taxes of the type imposed by Florida, in none of these agreements has the United States agreed to deny the states the power to tax the sale of aviation fuel; in particular, the agreement between the United States and Canada makes *no mention* of taxation by political subdivisions, "an omission which must be understood as representing a policy choice by the contracting parties. . . . " *Id.* at 11. This Court went on to say:

> "What all of this makes abundantly clear is that the Federal Government has not remained silent with regard to the question of whether States should have the power to impose taxes on aviation fuel used by foreign carriers in international travel. By *negative implication* arising out of more than 70 agreements entered into since the Chicago Convention, the United States has at least acquiesced in state taxation of fuel used by foreign carriers in international travel. Again, in the U.S.-Canadian Agreement only 'national' charges are barred, and we presume that drafters from two federalist nations understood this as representing a choice not to preclude local taxation. It would turn dormant Commerce Clause analysis entirely upside down to apply it when the Federal Government has acted, and to apply it in such a way as to *reverse* the policy that the Federal Government has elected to follow." *Id.* at 12 (emphasis in original).

Thus in *Wardair* the terms of the international agreements showed that the federal government had concurred in barring a type of tax application, but the terms of the bar, as United States law, restricted only the taxing powers of the nations, not of their respective states or other political subdivisions. Under *Wardair*, the implications to be found in such an action establish that in formulating federal law Congress has elected to permit the states to impose the tax application which is barred to the United States. *Id.* at 10, 12.

B. Even without the compelling facts in the history of the US/UK Treaty, under *Wardair* the terms of United States treaties, and Congress' refusal to legislate WWCR restrictions in the face of recurring demands for action, give rise to fully sufficient implications of congressional acquiescence in the states' use of WWCR.

As will be shown below at pages 20-24, there are clear, documented facts in the history of the US/UK Treaty which confirm beyond doubt that Congress has acquiesced in California's use of WWCR. But those facts are the icing on the cake, for even without them *Wardair* would apply to confirm the validity of the California practice.

The California Supreme Court accurately summarized this case's income tax treaty context as follows:

"[N]umerous bilateral tax treaties between the United States and other nations, although precluding use of formula apportionment by the signatory *national* governments, do not include within that prohibition political subdivisions such as the states. And while such tax treaties *do* include subnational governments within the scope of nondiscrimination provisions, they are *not* included within the prescription that the signatory governments employ an AL/SA methodology in taxing local branches of foreign corporations." PA C-27 (emphasis by the Court).[11]

Correctly applying *Wardair*, the California Supreme Court held that the terms of those treaties established an implied congressional acquiescence in state use of WWCR. PA C-34. Here both types of *Wardair* implications of Congressional acquiescence can be found in the provisions of the income tax treaties: (1) since restrictions on global uses of formula apportionment such as WWCR are placed on national but not state governments, an implication arises that the states were not to be subjected to such restrictions, and (2) since the same documents restrict some aspects of state income-based corporate taxation without barring state use of WWCR, consideration clearly was given to restricting state taxes; therefore the

[11] These income tax treaties specifically require the *national* governments to treat a branch of the foreign business in the taxing nation, for example, as "if it were a distinct and separate person engaged in the same or similar activities under the same or similar conditions and dealing wholly independently" with the rest of the corporation and with any other related corporations covered in another article. Ex. 40D (Canada, 1984, a country noted in *Wardair* as a nation with a federal structure), art. VII(2); see also Ex. 40A (Australia, 1983), art. 7(2); Ex. 40B (Austria, 1957), art. III; Ex. 40C (Belgium, 1972), art. 7(2); Ex. 40H (France, 1968), art. 6(2); Ex. 40I (Germany, 1954), art. III(2); etc. Although the nations are barred from using the unitary business concept for global methods of formula apportionment such as WWCR, within the arm's length context required by the treaties there can be (and is) considerable use of apportionment formulas. R 1899-1906; see JA A-423. As to the nondiscrimination clauses which apply to the states in some aspects of income taxation, the Barclays taxpayers have conceded for this litigation that those clauses do not bar state use of WWCR. R 1815-24.

implication of permission for state use of WWCR is doubly confirmed.

In at least one way the permissive implications of the treaty provisions are stronger in this case than in *Wardair*. Whereas in *Wardair* the two types of provisions giving rise to the two types of implications were not found in the same document, most of the income tax treaties now before this Court are documents containing both types of provisions, thus giving the resulting implications a mutually reinforcing synergy which they would not otherwise generate. The drafters of the income tax treaties now at issue obviously knew about the existence of global formula apportionment tax accounting methods such as WWCR.[12] The drafters of these income tax

[12] The possibility (and validity under the United States Constitution) of state application of formula apportionment to foreign businesses has been a matter of clear international notice since at least 1924, when this Court approved New York's application of a unitary business/formula apportionment approach to a British corporation in *Bass, Ratcliff & Gretton* v. *State Tax Commission*, 266 U.S. 271 (1924). As recognized by Barclays (Br.Pet. 7), " 'The League of Nations rejected formulary apportionment (unitary tax) many years ago.' " Thus the California Supreme Court properly refused to accept the supposition that global unitary business formula apportionment as an alternative to separate accounting did not "penetrate the international financial and diplomatic consciousness until the multinational corporate boom of the 1970's." PA C-32.

California did not suddenly change its basic approach in the 1970's – the multinational corporate boom merely brought many more multinational, multicorporate businesses within the natural application of California's multicorporate formula apportionment. JA A-791 to A-792; see also PA C-33 to C-34. This Court's first affirmation of California's use of the unitary method was in 1942, for tax year 1936. *Butler Bros.* v. *McColgan*, 315 U.S. 501, 503 (1942). Multicorporate inclusion within the unitary formula was recognized in *Edison California Stores* v. *McColgan*, 30 Cal.2d 472 (1947). If a taxpayer's business is unitary, California's statute (dating back to 1929) requires application of full formula apportionment. *Honolulu Oil Corp.* v. *Franchise Tax Board*, 60 Cal.2d 417, 425 (1963).

In any event, the list of 40 bilateral treaties which the Executive Branch supplied to the California Supreme Court in 1991 shows that 28 dated from 1970 or later. PA H-10 to H-11. There can be no doubt that the drafters for all 40 of these treaties, which required separate accounting for the national governments, were fully aware of the global unitary business formula apportionment alternative; otherwise, why have the restriction?

treaties obviously were aware that such treaties could impose the same types of limitations on the states as they were imposing on the federal government. Barclays characterizes these provisions as "remote and general." Br.Pet. 40. If Barclays' standards of remoteness and generality had been applied to the provisions from the separate documents in *Wardair*, those documents never would have qualified for recognition by this Court as containing implied acquiescence by Congress for the *Wardair* state tax.[13]

Outside of the treaty context, the California Supreme Court also properly found implied congressional acquiescence for state use of WWCR in the repeated refusals of Congress to enact statutes which would have restricted such use. Ordinarily, and quite appropriately, courts are slow to attribute significance to the failure of Congress to act on particular legislation. However, when the status quo on a highly controversial issue has been challenged in legislative hearings and in repeated attempts at legislation, none of which has ever successfully emerged from any committee, even though other measures on the subject have successfully gained congressional approval, then Congress' inaction supports a conclusion of implied acquiescence. *Bob Jones University* v. *United States*, 461 U.S. 574, 600 (1983). Under those circumstances,

> "It is hardly conceivable that Congress – and in this setting, any Member of Congress – was not abundantly aware of what was going on. In view of its prolonged and acute awareness of so important an issue, Congress' failure to act on the bills proposed

[13] The California Supreme Court also recognized that as early as the late 1940's United States negotiators of Friendship, Commerce and Navigation ("FCN") treaties "incorporated standards to preserve the states' freedom to employ methods that produced a tax 'reasonably allocable or apportionable' to the taxing jurisdiction" (PA C-33); the Court noted that this standard was viewed by the United States drafters "as 'intended to cover all the various methods, proportionate or otherwise, by which a reasonable tax base might be determined.' (U.S. State Dept., Standard Draft Treaty of Friendship, Commerce and Navigation, prepared by Charles H. Sullivan (Aug. 1980) pp. 202, 203.)" PA C-27. Therefore, the FCN treaties complement the income tax treaties in preserving the states' ability to use formula apportionment methods such as WWCR.

> on this subject provides added support for concluding that Congress acquiesced in the [status quo, which in *Bob Jones* consisted of] IRS rulings of 1970 and 1971." *Id.* at 600-01.

The same special circumstances are present in this case: "vehement and unrelenting international opposition" (Br.Pet. 36) to state use of WWCR, including statements of foreign officials to Congress (see, *e.g.*, JA A-215 to A-218), has resulted in numerous attempts over the past decades to restrict that use. In the words of the California Supreme Court,

> "The parties agreed in a pretrial stipulation that 'various proposed Legislative bills have been introduced in the United States Congress that would, among other things, affect the state's use of worldwide combined reporting.' The stipulation identifies twenty such House and Senate bills spanning twenty years. These range from House Resolution No. 11798 introduced in the House in 1965 (an ambitious 'Interstate Taxation Act' that would have required the states to adopt a two-factor apportionment formula in taxing unitary groups) to 1985 legislation sponsored by the Treasury Department that would have limited state use of worldwide formula apportionment to members of foreign-based corporate groups actually doing business in the United States, that is, so-called 'water's edge' legislation. . . . None of these measures was enacted into law by Congress." PA C-30 to C-31.

The stipulation also noted and contained at least nine congressional committee reports (six of which did not pertain to treaties) which considered state tax issues including WWCR. JA A-23 to A-24, A-47; also see JA A-201 to A-209. Barclays concedes that, like the attempts at legislation detailed in *Bob Jones University,* none of the attempts to legislate restrictions on *state* use of WWCR ever gained even committee approval (Br.Pet. 40), while treaty restrictions on the *federal* government's use of formula apportionment (including WWCR) routinely received Senate approval. As noted by the California Supreme Court (PA C-29), in 1978 Senator Church observed in the Senate hearings on the US/UK Treaty that "For some ten years Congress has been rejecting the type of limitation

on the power of our State governments to tax [using WWCR] which is incorporated in article 9(4) of the pending treaty." JA A-252. Congress has continued to do so ever since, both before and after the Executive Branch in 1986 publicly called to a halt its federal legislative efforts in an effort to obtain a cooperative resolution with the states. JA A-440 to 441.

These extraordinary circumstances parallel the circumstances in *Bob Jones University* which led this Court to find additional acquiescence in Congress' repeated failure to act on a particular type of legislation. In this case repeated congressional refusal to restrict by statute the states' use of WWCR provides an additional indication of congressional acquiescence in such use. As held in *Wardair*, implied acquiescence by Congress in a particular state tax practice is sufficient to remove that practice from all dormant Commerce Clause scrutiny.

C. Application of *Wardair* to the provisions and history of the US/UK Treaty compellingly establishes congressional acquiescence in state use of WWCR.

In holding that the *Wardair* rule was applicable in the present case, the California Supreme Court placed its primary reliance on the US/UK Treaty, which by its terms has effect in the United States generally for tax years beginning on or after January 1, 1975. JA A-474 to A-475. (Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasions with Respect to Taxes on Income and Capital Gains (JA A-444 through A-476).) For the first and only time, in 1975 treaty negotiations the Executive Branch agreed on a treaty provision, here article 9(4), which would have explicitly prohibited any state use of WWCR. JA A-243; see Appendix A hereto for art. 9(4).

After much debate, the entire treaty, with the state WWCR ban, was rejected by the Senate in 1978 (see JA A-392 to A-394). On reconsideration, the treaty achieved the required two-thirds vote for approval only when the WWCR prohibition was rendered totally inapplicable to the states by a

reservation. JA A-238 through A-417 (Senator Church's reservation at A-251, final 6/27/78 vote at A-408 to A-410). In renewed bargaining, the United Kingdom exacted other federal tax concessions from the United States in exchange for dropping the ban on state use of WWCR. JA A-437. Only then did the United Kingdom accept the treaty with the revised prohibition of WWCR applicable solely to the national governments, not to the states. JA A-429 through A-432; JA A-200, A-227 to A-229. Thus the states' use of WWCR was directly considered as a tax issue during the formulation of the treaty, but the *states'* use of WWCR ultimately was not restricted in the final adoption of the treaty as a part of United States law.

The US/UK Treaty provides a perfect context for the application of the *Wardair* rule: a clear congressional consideration of whether a state tax practice (WWCR) should be restricted, and a final ratification of a treaty which by clear implication permitted the states' continued application of that tax practice (WWCR). At the time of the final Senate vote, the clear and publicly acknowledged choice before the Senate was either to ratify the US/UK treaty while permitting the states to use WWCR or (since ratification with original article 9(4) had proved impossible) not to ratify the treaty. See 124 Cong. Rec. 18709-12 (June 23, 1978) (JA A-394 through A-407 – statements of Senators Byrd, Church, Javits, Stevens, Sparkman, Cranston and Packwood).[14]

By more than the required two-thirds vote (82 yeas, 5 nays), the Senate chose to ratify the treaty while permitting (by implication) state use of WWCR. 124 Cong. Rec. 19076 (June 27, 1978) (JA A-408 to A-410). In the words of the *Wardair* decision, the Senate has "at least acquiesced" in the continued use of WWCR by the states, and under the *Wardair*

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[14] For example, Senator Javits, who had been the main proponent of the treaty as negotiated and the main opponent of the Church reservation, stated, "I will vote for the treaty with the Church reservation incorporated in it. I cannot vote for the Church reservation [separately]. I am not a fool; I opposed it. I think it is wrong. But on balance if I have got a treaty and that is the price of it I am going to pay it. So I really hope that is the route we will go." JA A-404.

holding such acquiescence is fully sufficient to establish that the federal government has "affirmatively decided to permit" state use of WWCR. 477 U.S. at 12-13.

The California Supreme Court correctly compared the present case to *Wardair*:

> "The parallels between this evidence of 'governmental silence' or refusal to act and that regarded as decisive in *Wardair, supra*, 477 U.S. 1, seem to us both evident and compelling. As in *Wardair*, an international agreement (here the bilateral income tax treaty between the United States and the United Kingdom) demonstrates that while federal executive branch officials *aspired* to eliminate a state tax practice (here the use of formula apportionment to calculate the tax liability of foreign-based multinationals), 'the *law* as it presently stands acquiesces' in the states' continued use of that practice. As in *Wardair*, the 'negative implications' of international agreements (here the tax treaty as ratified by the Senate) support recognition of a federal policy that *acquiesces* in the states' tax practice. And certainly, in the circumstances of Senate consideration detailed above, the explicit removal of 'political subdivisions' from the scope of article 9(4) effected by the Church reservation, like the omission of restrictions on taxation by political subdivisions in the international agreements considered in *Wardair*, 'must be understood as representing a policy choice by the contracting parties.' (*Wardair, supra*, 477 U.S. at p. 11.)" C-29 to C-30 (emphasis in original; footnote omitted).

Recognizing that formula apportionment such as WWCR has been a matter of international interest from at least the mid-1950's (C-33 to C-34), and noting that indications of such federal acquiescence also were to be found in the history of other bilateral income tax treaties (C-31 to C-34) (see above at pp. 15-18) and in legislative histories of congressional bills (C-31) (see above at pp. 18-20), the California Supreme Court applied *Wardair* to hold that (1) California's application of WWCR in this case has been permitted by Congress under its Commerce Clause powers, and (2) since

Congress has acted to permit such application, no dormant Commerce Clause analysis was necessary.

The establishment of congressional acquiescence is markedly clearer here than it was in *Wardair*. In *Wardair* this Court found that the *terms* of the treaties implied that restrictions upon the type of state tax at issue had been considered and rejected. Implications of at least equal strength can be found in the final terms of the US/UK Treaty. However, in this case the Court can confirm those implications by reference to the congressional record, which explicitly establishes intense congressional consideration and ultimate rejection of a ban upon the states' use of WWCR.[15] It is unmistakably clear that the ban on state use of WWCR which was negotiated between the Executive Branch and the United Kingdom could not obtain the two-thirds Senate approval required by article II, section 2, clause 2 of the United States Constitution. Under these circumstances it is unmistakably clear that the states' use of WWCR has gained the congressional acquiescence which is required under *Wardair* to take a case out of dormant Commerce Clause coverage.[16]

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[15] Barclays refers to a number of cases wherein this Court has not found congressional acquiescence for a particular state practice. Br.Pet. 37. But in none of these cases did the context show that a congressional action had been taken at a time when Congress had directly before it the type of state action in issue. For example, in *Wyoming* v. *Oklahoma*, 112 S.Ct. 789 (1992), this Court quite reasonably did not treat the Federal Power Act's general "saving clause," allowing otherwise valid state statutes to regulate sales of electrical energy, somehow to authorize Oklahoma to require the burning of Oklahoma coal in all coal-burning electrical power plants in Oklahoma. *Id.* at 802. In the present case there can be no question that Congress was aware of the foreign commerce issues of state use of WWCR when acting (as in the rejection of the US/UK Treaty's originally-negotiated state WWCR ban) in response to what Barclays itself refers to as "vehement and unrelenting international opposition" to WWCR. Br.Pet. 36.

[16] Barclays tries to weasel out of this result by claiming that the Constitution's requirement that treaties be approved by a two-thirds senate vote should be disregarded, and that the fact that a simple majority of senators voted for the treaty as negotiated should be determinative. This position is faulty in its logic and incredible in its disregard for the United States Constitution. As noted in senate debate, the WWCR ban showed up in the negotiated US/UK Treaty after ten years of failure in efforts to gain such a ban by statute; the treaty strategy was seen as a

D. Recent confirmation of *Wardair* in *Itel Containers*.

Barclays argues that the California Supreme Court somehow has gone beyond *Wardair* and other more recent decisions of this Court. That argument is fully destroyed by *Itel Containers International Corp.* v. *Huddleston*, 113 S.Ct. 1095 (1993), where this Court concluded its Foreign Commerce Clause discussion with a holding that "the most rational inference to be drawn" from congressional actions was congressional permission for the type of sales tax imposed by Tennessee in that case. *Id.* at 1105. In *Itel*, consistent with *Wardair*, this Court inferred the congressional permission from the simple fact that the state tax did not fall within the types of taxes which had been eliminated in "various conventions, statutes and regulations that restrict a States's ability to tax international cargo containers in defined circumstances. . . . " 113 S.Ct. at 1105. (But *cf. Japan Line, Ltd.* v. *County of Los Angeles*, 441 U.S. 434, 436 n. 1, 446 n. 10, 452-53 (1979), for a pre-*South-Central Timber*, pre-*Wardair* contrary application of the same container convention authority.)

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ploy to get around the inability to legislate such a ban head on. JA A-251 through A-253. The fact that a simple majority of the senators voted for the treaty as negotiated may just show the strength of the ploy – in order to get the rest of the treaty as negotiated, some senators may have been willing to swallow the WWCR ban. Aside from its illogical conclusion, Barclays' two-thirds vote argument is inconceivably flippant in its disregard of the constitutional structure of this federalist nation. It is not merely coincidental that the United States Senate is the body which was given the constitutional power to ratify or reject treaties as negotiated by the Executive Branch. The very makeup of the Senate, with equal representation for each state, is a built-in protection that the states' interests will be considered in the exercise of commerce or foreign affairs powers. *Garcia* v. *San Antonio Metro. Transit Authority* 469 U.S. 528, 551 (1985); see *The Federalist*, No. 62, p. 402 (Mod. Lib. ed. (1937)) (A. Hamilton or J. Madison). The requirement of a two-thirds affirmative Senate vote to ratify any treaty (U.S. Const. art. II, § 2) gives further protection to the interests of the states in the treaty process. See *id.*, No. 64, p. 422 (J. Jay), No. 75, pp. 489-90 (A. Hamilton). Under *Wardair*, which looks to "the *law* as it presently stands" (at 10 (emphasis by the Court)), the question is not what a simple majority of the senators would have *liked*; the question is what the Senate as a body *decided* under the rules set by the Constitution.

The single-justice dissenting opinion in *Itel* criticized the majority for "finding congressional authorization for the tax in congressional silence," by "infer[ring] permission for the tax from Congress' supposed failure to prohibit it." 113 S.Ct. at 1110 (Blackmun, J., dissenting). This echoes both the criticism of the *Wardair* majority opinion in the single-justice *Wardair* dissent and the criticism which Barclays has aimed at the California Supreme Court. While Barclays may not like the *Wardair* approach, there can be no valid question that the California Supreme Court's application of the *Wardair* rule is fully consistent with the current rulings of this Court.[17]

E. Executive Branch actions recognize the existence of the binding congressional foreign commerce decision to permit California's use of WWCR.

Two Executive Branch documents are cited in support of Barclays' claim that, "There is an express and well articulated

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[17] The decision in *Itel* concluded its Commerce Clause holding by quoting from *Wardair*: " 'It would turn dormant Commerce Clause analysis entirely upside down to apply it where the Federal Government has acted, and to apply it in such a way as to *reverse* the policy that the Federal Government has elected to follow.' " 113 S.Ct. at 1105 (emphasis in original). Barclays disregards the ultimate holding in *Itel* and treats *Itel* as a dormant Commerce Clause case. Br.Pet. 37-38. This Court's Commerce Clause discussion in *Itel* does include analysis of dormant Commerce Clause elements, with references to *Japan Line, Ltd.* v. *County of Los Angeles*, *supra*, and *Container*, *supra*. However, once the last, "one voice," element was reached, this Court focussed on the possibility that Congress had acquiesced in the type of state tax which was at issue. Realizing, under *Wardair*, that such acquiescence would be determinative of the Commerce Clause issue, this Court noted that within the *Itel* context the federal government had acted on the subject matter (state taxation of cargo containers and their use) without proscribing the type of state tax which was directly at issue in *Itel*. Under those circumstances (and utilizing the *Wardair* approach), this Court held in *Itel* that "the most rational inference to be drawn" is that the Tennessee Tax "is permitted." 113 S.Ct. at 1105. This is not a dormant Commerce Clause holding. If the Tennessee tax in *Itel* had *not* passed all the dormant Commerce Clause tests which were considered, the *Itel* Commerce Clause result still would have been the same. This Court's reaffirmation of the *Wardair* holding and approach makes clear that the Tennessee tax still would have been upheld, because Congress, in *non*-dormant actions, impliedly permitted such a state tax. Any other result " 'would turn dormant Commerce Clause analysis entirely upside down.' " 113 S.Ct. at 1105.

policy of the United States on the system to be used for division of income of foreign multinational enterprises among nations for tax purposes. It is the arm's length method." Br. Pet. 23. The first document offered in support of this claim is a 1984 statement by Under Secretary of State Wallis regarding the Worldwide Unitary Taxation Working Group, a statement which begins, "I support the Working Group's recommendation for a 'water's edge' limitation on unitary taxation. . . . " JA A-576. The Working Group's recommendation was for *state* legislation to achieve the *water's edge* result. Ex. 29. The second document is the 1986 letter from Secretary of State Schultz to California Governor Deukmejian, noting the introduction of federal (water's edge) legislation, indicating that Secretary Schultz "believe[d] state worldwide unitary taxation to be inappropriate," and urging "swift legislative or administrative action" by California. This letter was intended to encourage water's edge legislation under the Working Group's recommendation. JA A-601 through A-603; Ex. 37I, Statement of J. Roger Mentz, pp. 12-14.

Although these documents note the federal use of and Executive Branch preference for separate accounting, the clear Executive Branch "policy" embodied in these documents is to encourage WWCR states to legislate water's edge alternatives. But no matter what these documents contained, they could only voice the "*aspiration*" of the Executive Branch; they could not constitute the Commerce Clause "*law* as it presently stands," as is required to bind the states and this Court under the Commerce Clause. *Wardair*, 477 U.S. at 10 (emphasis by the Court).

Whatever the Executive Branch's *aspirations*, the Executive Branch's *actions* recognize the existence of the congressional Commerce Clause decision to permit the states' use of WWCR. Some examples: (1) except for its 1975 negotiation of the ultimately rejected state WWCR ban in section 9(4) of the US/UK Treaty, the Executive Branch has *never* negotiated an income tax treaty or FCN treaty that would either restrict

or prohibit California's use of WWCR (see JA A-243);[18] (2) in 1963 and 1977 the Executive Branch formally reserved its approval of the OECD Model Treaty clause which would make AL/SA requirements in the treaty applicable to subnational taxes (Ex. 44, JA A-501); (3) in December 1993, in conjunction with the General Agreement on Tariffs and Trade, the Executive Branch concluded negotiations on the General Agreement on Trade in Services, which contains language which would provide that state taxes, such as California's unitary tax method (even before its current revision) would not be considered discriminatory;[19] (4) the following Executive Branch testimony was given in 1979 to explain the administration's exclusion of state taxes from the overall coverage of its own Model Income Tax Treaty (Exh. 45, at JA 560):

> "These local U.S. taxes are not covered because it is unlikely that the United States would consent to the ratification of any treaty provision that restricted the rights of the various states to impose their own taxes." JA A-438 (statement of Donald C. Lubick).

Thus the actions of the Executive Branch establish not only the absence of a clear federal directive *prohibiting* WWCR; those actions also establish the Executive Branch's continuing recognition of the congressional Foreign Commerce Clause determination to *permit* California to use WWCR.

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[18] In later negotiations for the income tax treaty with Canada, Canada indicated its unhappiness with state use of WWCR, but both the United States Executive Branch and the Canadian representative expressed the understanding " 'that the Senate of the United States has not consented to any limitation on the taxing jurisdiction of the states by a treaty and that a provision which would have restricted the use of unitary apportionment in the case of United Kingdom corporations was recently rejected by the Senate.' " Therefore, no such limitation was attempted in the treaty with Canada. Ex. 42, JA A-477 through A-478. An identical statement was contained in correspondence exchanges relating to the treaty with France, with the same result. Ex. 43, JA A-480 through 483.

[19] Statement attributed to Assistant Treasury Secretary Daniels in BNA Daily Tax Report (12/14/93), p. G-5.

III. A DORMANT COMMERCE CLAUSE ANALYSIS WOULD LEAD TO THE SAME RESULT: THE VALIDITY OF CALIFORNIA'S USE OF WWCR.

A. There would be no basis for this Court to require uniformity with federal practices under a "one voice" dormant Commerce Clause analysis.

1. In this case Congress has at least indicated that federal uniformity is not essential; therefore this is not an appropriate case for this Court to take any "one voice" action.

Proper application of *Wardair* renders unnecessary any dormant Commerce Clause analysis. Pages 28 through 45 of this brief, which are devoted to such an analysis, should not be necessary. Moreover, the following expedition through the "quagmire" of dormant Commerce Clause analysis (see *Northwestern Cement Co.* v. *Minn.*, 358 U.S. 450, 458 (1959)), leads the reader back to the same conclusion – California's use of WWCR is valid under the Commerce Clause.

The "one voice" element of dormant Commerce Clause analysis involves an area in which this Court has stated it has "little competence" – the area of foreign policy – "whose nuances, we must emphasize again, are much more the province of the Executive Branch and Congress than of this Court. . . . " *Container*, 463 U.S. at 194, 196. Thus this Court is careful to erect a high entry requirement to this analysis: if the state tax does not impair federal uniformity in an area where *federal uniformity is essential*, or if it does not " '*prevent*[] the Federal Government from "speaking with one voice" in international trade,' " *id.* at 193 (emphasis added), this Court will not act in the place of Congress. Thus this judicial function is characterized more by judicial restraint than by judicial action: the Court acts only to prevent irremediable national injury when circumstances inhibit Congress' ability to speak with its authoritative "one voice" under the Foreign Commerce Clause.

It has already been shown above (at pp. 18-20) that Congress has been presented with this issue at least twenty times and has not acted to restrict the states' use of WWCR. Even if this inaction in the face of "vehement and unrelenting international opposition" to WWCR (Br.Pet. 36) did not clearly imply congressional permission for the states to use WWCR (but it does – see above at pp. 18-20), it must at least establish that Congress does not find the issue to be one in which federal uniformity is *essential*. If uniformity were deemed by Congress to be essential, uniformity would have been legislated long before now. Why should this Court act like Congress to legislate uniformity when Congress itself, having had much time and many opportunities to legislate on its own, has plainly decided that it will do nothing to restrict state WWCR use?

In *Quill Corporation* v. *North Dakota*, ___ U.S. ___, 112 S.Ct.1904 (1992), this Court declined to change established law, indicating that, since it involved the Commerce Clause, "the underlying issue is not only one that Congress may be better qualified to resolve, but also one that Congress has the ultimate power to resolve." *Id.* at 1916 (footnote omitted). Therefore, even though the Court recognized certain problems with the status quo, this Court left any action to Congress, with the observation that " 'Congress has the power to protect interstate commerce from intolerable or even undesirable burdens.' " *Id.* The same approach is just as appropriate in this foreign commerce case.

2. Federal uniformity is not essential when, as here, the Executive Branch has achieved harmony through cooperative efforts in the political sphere.

In contrast to Congress' resolute inaction as to federal legislative restrictions, the Executive Branch has been resolutely active in attempting to bring about a cooperative resolution of the problem through state enactment of water's edge legislation. As noted above at pages 25-27, the Executive Branch "policy" underlying the documents relied upon by Barclays was the policy formed and recommended by the

Worldwide Unitary Taxation Working Group – to encourage the WWCR states to enact water's edge unitary combination statutes.[20] In his 1984 transmittal letter to President Reagan, the Secretary of the Treasury, as chairman of the Working Group, stated, "If states enact legislation based on the three principles agreed upon by the Working Group, the United States will be able to speak with one voice in dealing with its foreign trading partners, and this irritant to international commercial relations will have been eliminated." Ex. 29 at iii.

Accomplishment of this goal has not been easy, but it has been accomplished. More than a year after the Working Group's report was released, the White House press office issued a "Statement by the President" which indicated that since the unitary states had not universally enacted water's edge statutes, the Executive Branch would be crafting federal legislation to require the water's edge approach, entering into negotiations to amend double taxation agreements, and having the Attorney General protect the United States' interests in appropriate cases (including, eventually, appearances in *Barclays* but not *Colgate*). PA H-46. The federal water's edge legislation was introduced in late 1985.

In 1986 California enacted water's edge legislation, but with certain conditions which engendered their own controversies. JA A-696 through 745. The Executive Branch stated to Congress later in 1986 that "state legislative developments [by California and other states] go a long way toward resolving the difficult unitary tax issue" and "illustrate the successful operation of the Federal system." JA A-440. Although problems remained, the Executive Branch took the position "that restrictive Federal legislation is not warranted at this time" and that no "treaty resolution of the unitary issue is

20 The Working Group agreed on "Three principles of Agreement": "Water's edge unitary combination for both U.S. and foreign based companies," "Increased federal administrative assistance and cooperation with the states to promote full taxpayer disclosure and accountability" and "Competitive balance for U.S. multinationals, foreign multinationals, and purely domestic businesses." The first principle, water's edge treatment, "would be implemented by state action rather than federal restrictions." Ex. 29, Chairman's Report, pp. 9-10.

necessary or appropriate at this time." Credit was given to President Reagan's "decision in 1983 to seek a cooperative solution" by forming the Working Group. JA A-441 to A-442. The amicus brief which had been filed in this case as part of the strategy to encourage California to enact water's edge legislation (Ex. 37I, Statement of J. Roger Mentz, pp. 13-14) was not withdrawn, apparently to induce California to "respond[] to the federal initiative" (see *id.*) by achieving full harmonization with the Working Group's recommendations.

Finally, in 1993 California amended its water's edge election statute to eliminate all election fees and remove other controversial conditions. See App. A to Supplemental Brief of Respondent Franchise Tax Board in Opposition to Petition for Writ of Certiorari.[21] According to the Solicitor General's October 1993 brief in this case (page 10), the 1993 California legislation had the following result:

> "By removing any mandatory requirement or economic compulsion for taxpayers to report their income under the worldwide combined reporting method, California's recent modifications of its tax system have brought that State's law into acceptable harmony with federal and international 'arm's length' tax practice."

Thus the federal system has been utilized to achieve an accommodation of the international tensions arising from California's use of WWCR. Ten years after the formation of the Working Group, California legislation has been achieved which meets the principles enunciated by the Working Group. As noted by the Secretary of the Treasury in 1984 (see above at p. 30), such enactments enable the United States "to speak with one voice in dealing with its foreign trading partners. . . . " Just as it would turn dormant Commerce Clause analysis entirely upside down to apply it when Congress has acted to permit the state action in issue (see *Wardair*, 477 U.S. at 12), it would turn dormant Commerce Clause analysis completely

21 The United Kingdom immediately responded by officially indicating that "the UK will therefore defer retaliatory action. . . . " Pet. Supp. App. P, in Supplemental Brief of Petitioner.

inside out to apply the "one voice" element to bar state action under these circumstances. Such "one voice" application at this time would inject the courts into an area in which their competency is admittedly quite limited and would, by disregarding the harmony which has been achieved through cooperative federal/state action, infringe upon what this Court in *Container* termed "the sovereign right of the United States as a whole to let the States tax as they please." 463 U.S. at 194.

As this Court recognized recently in *Allied-Signal, Inc.* v. *Director, Div. of Taxation*, 112 S.Ct. 2251 (1992), "[I]f anything would be unworkable in practice, it would be for us now to abandon our settled jurisprudence defining the limits of state power to tax under the unitary business principle." To do so "would disrupt settled expectations in an area of the law in which the demands of the national economy require stability." *Id.* at 2262. This thought from *Quill Corporation* v. *North Dakota*, 112 S.Ct. 1904, 1916, is fully apposite here:

> "In this situation it may be that 'the better part of both wisdom and valor is to respect the judgment of the other branches of the Government.' "

3. No foreign retaliation is justifiable under the circumstances of this case.

For the reasons already given, this is not an appropriate case for this Court to act in the role of the "one voice" emergency police to safeguard national interests regarding foreign commerce, even if it were assumed that retaliation by foreign governments somehow could be justified. In any event, there is absolutely no basis for justifiable retaliation here.

In the portion of the *Container* "one voice" discussion which was truly a *dormant* Commerce Clause analysis, this Court tested whether California's application of WWCR in the *Container* context might "justifiably lead to significant foreign retaliation." *Id.* at 194. Under the *Container* facts this Court found that three factors (discussed below at p. 37) weighed against there being any such *justifiable* retaliation,

but the Court did not indicate that those factors were the only factors which would apply in every case.

a. Foreign disagreement with United States Supreme Court constitutional doctrine cannot make retaliation constitutionally justifiable.

In its brief, Barclays claims that California's use of WWCR "understandably" (not justifiably) has offended foreign nations. Barclays asserts that WWCR is "*perceived* by foreign nations as an arbitrary, unfair, and predatory method of taxation, the use of which threatens the international standard, imposes unreasonable tax and compliance burdens on foreign-owned taxpayers, and discourages foreign investment in the United States." Br.Pet. 16 (emphasis added).

Disagreement with California as to the fairness and propriety of WWCR cannot form a basis for any "justifiable" retaliation, no matter how "understandable" it might be. To pick a fight with California on this point is to challenge the authority of this Supreme Court. As noted above, this Court in *Container* held California's version of WWCR to be a "proper and fair method of taxation" (463 U.S. at 184) which "reflect[s] a reasonable sense of how income is generated" (*id.* at 169) and which avoids the "basic theoretical weaknesses" of arm's length/separate accounting methods (*id.* at 181). Among the separate accounting weaknesses pointed out in *Container* are that separate accounting "is subject to manipulation and imprecision, and often ignores or captures inadequately the many subtle and largely unquantifiable transfers of value that take place among the components of a single enterprise" (*id.* at 164-65).

Clearly, the foreign governments in Barclays' "perception" reference do not agree with the United States Supreme Court's favorable conclusions regarding the inherent merit of California's WWCR methods. While such foreign nations' reaction might be *understood* if they honestly held these misconceptions as to WWCR, that reaction cannot be *justified* on a basis directly contrary to an applicable and explicit

Commerce Clause holding of the United States Supreme Court.[22] (See also below at pp. 40-43 for misconceptions as to costs of complying with WWCR.)

b. Great Britain cannot justifiably retaliate for a state tax practice it has agreed to in a binding treaty.

It is particularly clear that retaliation by the United Kingdom cannot be justified. In the creation of the US/UK treaty that is still in force, the United Kingdom tried and failed to outlaw American states' use of WWCR. After the Senate refused to ratify the treaty unless the states were removed from the coverage of article 9(4)'s WWCR ban, the parties to the treaty entered into the Third Protocol, which made the prohibition contained in article 9(4) applicable only to the national governments, thus allowing continued WWCR use by the states. JA A-429 to A-432. The United Kingdom only agreed to this result after extracting other concessions from the United States in return. JA A-434, A-437. (In a separate statement the British, while disavowing any "approval" by the UK of WWCR, acknowledged both UK acceptance of the senate reservation against article 9(4) and

[22] This Court's 1983 recognition of the shortcomings of AL/SA has been borne out in the subsequent experience of federal tax authorities. In July 1990 I.R.S. Commissioner Fred T. Goldberg testified to Congress that, due to foreign corporations' AL/SA manipulations resulting in underreporting of income, the United States government is "being short-changed billions of dollars annually." *Tax Underpayments by U.S. Subsidiaries of Foreign Companies: Hearings Before the Subcomm. on Oversight of the House Comm. on Ways and Means,* 100th Cong., 2d Sess. (July 10 and 12, 1990) 72, 73. After hearing the testimony, Subcommittee Chairman J.J. Pickle concluded that underreporting by the U.S. subsidiaries of foreign multinationals was costing the U.S. Treasury a "sizable" figure, specifically referring to the opinion of one witness who testified that the tax shortfall exceeded $30 billion yearly. *Id.* at 380, 361. The problem continues, with gross taxpayer abuses of AL/SA transfer pricing provisions (which supposedly adjust intercompany sales to "arm's length" prices): "Transfer pricing is the most significant international compliance issue faced by the United States in recent years." Treasury Dept.-I.R.S. Joint Statement of Policy and Action Plan on International Tax Compliance (12/17/93); BNA Daily Rpt. for Executives (12/20/93).

the difficult issues raised "in seeking to limit State taxing powers" through treaties. JA A-99. That statement also recognized the final balance of the bargaining, proclaiming "the achievement of the two Governments in reaching a fair and balanced agreement." JA A-96 through A-97.) Under these circumstances, any United Kingdom retaliation for California's use of WWCR would be in violation of the bargained-for US/UK Treaty and thus clearly not justifiable. The Executive Branch has explicitly recognized that implementation of the latent UK retaliatory measure would clearly violate the US/UK treaty. Executive Branch testimony to Congress includes the following statement regarding the United Kingdom's retaliatory measure:

> "We believe that its existence is inconsistent with the U.S.-U.K. bilateral income tax treaty to the extent its threatened use causes U.S. taxpayers to refrain from claiming benefits under the treaty. *Its actual implementation would be a clear violation of the treaty.*" JA A-443 (emphasis added).[23]

c. Even if retaliation had once been justifiable, California's "water's edge election" would render retaliation currently unjustifiable.

As established above at pages 28-32, this Court's proper role in "one voice" issues is to "hold the fort" in protecting the national interest as to foreign commerce issues until Congress and the Executive Branch have had the chance to act. Even if it were determined that Congress had not acted to permit California's use of WWCR, Congress clearly has had the opportunity to act. The Executive Branch has been quite

[23] Barclays quotes the superseded opinion of the Court of Appeal as asserting that although the UK retaliatory provision has never been implemented, " 'many' " American companies have been " 'propelled' " into " 'preimplementation compliance.' " Br. Pet. 26. The evidence in this case indicates that "some" ("one or two") American companies changed how they managed their funds in light of the existence of the dormant statute (R 180, 442), but this would not constitute compliance.

active and successful in achieving the cooperative harmonization of state tax prerogatives with national foreign policy interests, culminating in the Executive Branch's satisfaction with current California water's edge legislation.

Barclays is dialing "911" to ask this Court to take action as the ultimate "one voice" police force, a role this Court reluctantly assumes only when the courts must act to prevent imminent damage to national foreign commerce interests. But "911" calls are for emergencies, and there is no emergency here – Barclays is calling for this Court to invalidate a previous tax method, citing unjustified foreign retaliation threats which have now ebbed. This call for action should receive the same response which the police would give a "911" caller who wants emergency police action now to deal with a former problem which has been solved peacefully by neighborhood cooperation. It would be absurd for a state tax to be invalidated on a "one voice" basis of threats of foreign retaliation when under current circumstances those threats have absolutely no substance.[24]

[24] In its attempts to establish unconstitutionality, Barclays points to many events subsequent to 1978, such as UK enactment of retaliatory legislation in 1985. Br.Pet. 26. Twisting 180 degrees, Barclays then argues that "Subsequent Events [namely, California's enactments of water's edge legislation] Do Not Eliminate Unconstitutionality." Br.Pet. 41. The cases Barclays cites for its second approach to subsequent events deal with the rules for retroactive relief in discrimination cases. Those cases have nothing to do with the "one voice" element. There is a substantive difference in what interests are being protected when considering whether a state statute (1) discriminates against a taxpayer or, (2) as *Container* puts it (463 U.S. at 193), " 'prevents the Federal Government from "speaking with one voice" in international trade. . . . ' " The "one voice" protected interest is primarily that of the United States, with the taxpayer getting the benefit of the rule if, at the time of ultimate decision, conditions still exist which merit court action in the protection of that interest. If Congress has indicated that it can but does not wish to speak, and if the Executive Branch has adequately resolved the foreign affairs problem and indicates that it does not need or wish the Court's intervention, then intrusive court action would frustrate, rather than protect, the national interest which the "one voice" element is designed to protect.

d. Consideration of the three factors from *Container* does not establish any justifiable retaliation.

Given the above, there is no way that any foreign retaliation in this case is "justifiable." Under these circumstances the primary reason to consider the three retaliation factors which the *Container* decision applied to a unitary business headed by a domestic corporation (463 U.S. at 194-95) is to note how Barclays has tried to warp two of them into new tests favorable to Barclays. Under the first factor, Barclays must apply an admittedly non-*Container* definition of "automatic asymmetry" to try to pass the *Container* "automatic asymmetry" test. Under the test as actually applied in *Container*, this case presents no inevitable double taxation (see below at pp. 37-39), and therefore there is no automatic asymmetry. Similarly, Barclays would rewrite the third *Container* factor to be some sort of "allocation factor" test, while the whole point of the test as applied in *Container* is that "the fact remains that [taxpayer] is without a doubt amenable to be taxed in California in one way or another, and that the *amount of tax it pays* is much more the function of California's tax rate than of its allocation method." 463 U.S. at 195 (emphasis added). That is true here as well as in *Container*. Of course, the second factor in *Container* merely reserved the question which is presented for decision in this case. For the reasons already given above, it has been established that there are no valid grounds to apply the "one voice" element of dormant Foreign Commerce Clause analysis to invalidate California's 1978 application of WWCR to the taxpayers now before this Court.

B. There is no enhanced risk of double taxation violative of dormant Commerce Clause standards.

Barclays is wrong in claiming that "the taxpayers here unquestionably have established that double taxation has occurred." Br.Pet. 32. Certainly, under *Container* California's calculation of the worldwide net income of the unitary business before separating out California's share of that income

by WWCR does not by itself result in California's taxation of more than California's share. Compare Br.Pet. 33. Also, merely introducing the taxpayers' foreign returns (see Br.Pet. 32) does not establish multiple taxation.[25] In any event, even if, as in *Container*, it were to be assumed that double taxation exists, there would be no violation of the multiple taxation element of the dormant Foreign Commerce Clause analysis.

Barclays' double taxation analysis ignores the thrust and holding of *Container*'s multiple taxation section. Barclays would like to apply the multiple taxation test as framed for property taxes in *Japan Line*. However, in *Container* this Court made clear that it would be inappropriate to apply the *Japan Line* test to income taxation. 463 U.S. at 192-93. In doing so, this Court recognized that any method of income allocation for income taxes is an inexact process akin "to slicing a shadow." *Id.* at 192. Recognizing that the separate accounting rules of the various countries "often differ substantially" (*id.* at 191, 192-93; see in this case R 1772 (JA A-836), R 1789-91), this Court held that requiring California to use separate accounting "could not eliminate the risk of double taxation of corporations subject to its franchise tax, and might in some cases end up subjecting those corporations to more serious double taxation than would occur under formula apportionment." *Id.* at 191 (footnote omitted). Under these circumstances, and since California's tax method did not necessarily result in " 'inevitable' " double taxation in every case, this Court held that California's use of WWCR

[25] The United Kingdom's taxing authority recognizes that the method by which California or any other jurisdiction determines the amount of taxable income assigned to it is not controlling for purposes of calculating the United Kingdom's tax credits for avoidance of double taxation. Ex. 51W. The final California assessments attributed net income of £ 76,232.59 to BBI's California activities. Ex. 51V. That amount was less than 1/75 of all BBI profits attributed to the United States for purposes of the U.K. double tax credit. Ex. 51J. The BBI income attributed to California under WWCR clearly falls within the total income which the UK would attribute to the United States, and the California tax is therefore creditable. Since Barcal was a California corporation (JA A-11) and did not pay any dividends to its United Kingdom parent, BBI (Ex. 51W), there was no Barcal intercorporate dividend problem as contemplated in *Container*, 463 U.S. at 192 n. 30.

passed the dormant Foreign Commerce Clause test as to the enhanced risk of multiple taxation. *Id.* at 192-93.

Barclays has been unable to convince any court that the multiple taxation result would be any different in the present case. Barclays looks not to the *Container* holding (*id.* at 189-93), which supplies the multiple taxation test for income tax cases such as *Barclays*, but to the preliminary discussion in *Container* (*id.* at 187-89), which reviews certain differences and similarities between *Container* (an income tax case) and *Japan Line* (a property tax case). Br.Pet. 32-33.[26] While Barclays strains mightily to draw "one voice" considerations into the multiple taxation context, Barclays' analysis totally fails to recognize this Court's clear (and clearly applicable) multiple taxation holding: because California's WWCR does not result in inevitable multiple taxation in every case, and because requiring separate accounting would continue (and in some cases increase) the risk of multiple taxation, California's use of WWCR *in the income tax context* cannot be violative of the multiple taxation element of dormant Foreign Commerce Clause analysis.

[26] In *Itel Container Intern. Corp.* v. *Huddleston*, 113 S.Ct. 1095, 1103-04 (1993), this Court, in also distinguishing *Japan Line*, noted two major characteristics in *Container* which distinguished that case from *Japan Line*: (1) the double taxation problem was not the inevitable result of the California taxing scheme, and (2) the Executive Branch had decided not to file a brief in opposition to the tax. Both characteristics also apply to the present United States Supreme Court proceedings.

C. California's WWCR requirements are fully consistent with the nondiscrimination element of dormant Commerce Clause analysis.

1. Barclays' discrimination arguments are based on a compliance cost premise which disregards both authoritative California law and uncontradicted evidence.

Barclays bases its "discrimination" arguments on a totally false premise: that taxpayers cannot use any reasonable approximations when complying with California WWCR requirements. That was the mistaken premise adopted by the trial court, which found that the Barclays Group would have to spend millions of dollars setting up parallel sets of accounting books around the world in order to comply with the California law; it was those costs which the trial court found to be " 'prohibitive.' " See Br.Pet. 44 & n. 13. It was that mistaken premise which also led the Court of Appeal in its first opinion to term the California compliance burdens to be an "administrative nightmare." Br.Pet 44.[27] In its last opinion, the California Court of Appeal recognized that reasonable approximations were not only available to, but were used by, the Barclays taxpayers. PA D-13 to 14.

This Court has held that it is not free to overturn the California Court of Appeal's constructions of California state law when the California Supreme Court has denied review of

[27] No duplicate sets of books and records were needed to comply with WWCR. In addition to the general provision allowing the use of reasonable approximations, Barclays' " 'nightmare' " ignores the reality of other accommodating rules which are set forth in the compliance provisions of regulation 25137-6 (PA App. J). Those rules provide for net income determination by use of the regularly maintained financial records (records maintained in the parent's foreign currency, not dollars), then net income adjustments, only if material, to conform to United States GAAP and California tax accounting, and finally, after apportionment, the conversion of the net income result into dollars. The use of reasonable approximations in this process is explicitly permitted by the same regulation. Barclays' bizarre claim that use of reasonable approximations constitutes "wholesale non-compliance with the Regulation" (Br.Pet. 47 n. 15) is a wholesale misrepresentation of the regulation.

the case. *Hicks* v. *Feiock*, 485 U.S. 624, 629-30 (1988). The Court of Appeal's holding that California law permits the use of reasonable approximations when complying with WWCR, combined with the California Supreme Court's denial of review (PA App. E), provides the determinative interpretation of that state law. Barclays' attempts to premise its discrimination arguments on a contrary and erroneous interpretation of California law serve only to show Barclays' desperation in trying to cook up some basis for its position.

Although the Barclays taxpayers presented no evidence of their actual costs of compliance using reasonable approximations, defendant Board provided uncontested evidence concerning taxpayers' actual burden. Reference to the real world discloses that the Barclays taxpayers' compliance burden was not substantial.

During the 1970's, including the year at issue in this case, taxpayer BBI actually filed its California tax return on a WWCR basis (R 1441), including most but not all of the worldwide unitary business which BBI and the Board later stipulated to exist. As shown by the exhibits (Exs. RR, SS, TT, UU, (see JA 755 through 767) and 51P) introduced and discussed at pages 2113 through 2125 of the reporter's transcript, the California BBI returns were prepared by Price Waterhouse for income years 1972, 1973, and 1974; the most hours spent on any of those returns was 21 hours; the highest bill for the preparation of any of those returns was not in the millions of dollars, but was for $1,250. The reason is clear: these returns were prepared by using available documents and by applying the principles of materiality and reasonable approximations. The same is true of the income year 1977 (tax year 1978) WWCR return prepared by BBI itself. Although the Board found the unitary business to include more corporations than shown on the income year 1977 return, uncontradicted evidence (R 2115, 2124-25) indicates that preparation of the BBI return on this enlarged basis, using materiality and reasonable approximations, would take little more than 40 hours. Barclays' arguments and evidence regarding costs of compliance are purely hypothetical and have nothing to do with the facts of this case.

2. The use of reasonable approximations to comply with WWCR does not deprive any taxpayer, foreign or domestic, of tax benefits.

Barclays then argues that use of reasonable approximations would necessarily deprive a taxpayer of tax benefits. To the contrary, the record in this case contains uncontested instances of the availability of tax benefits (such as depreciation and bad debt deductions) within the California system's use of reasonable approximations and materiality. R 1467-69, 1471-72. The portions of the record cited on page 47 of the Barclays brief either (1) speak to what would be required to establish such tax benefits if reasonable approximations were not used, or (2) are fragments of testimony of witnesses who erroneously rejected the availability of reasonable approximations or who took the unrealistic position that one would have to know all the exact (and prohibitively costly) information before deciding whether to use any approximations.[28] *The Barclays taxpayers presented no evidence showing that they were actually deprived of any tax benefit in this case* because of the reasonable approximations which were in fact used to determine their final liabilities.

In any event, if the use of reasonable approximations somehow meant that tax benefits would become unavailable, the federal tax law's arm's-length method would fail in the same manner, for, as the taxpayers' own expert witness testified, application of the federal system also depends on the use of reasonable approximations. JA A-829; see also 26 C.F.R.

[28] Since this issue involves questions of materiality of differences between benefit amounts derived from financial records and benefit amounts derived from fully developed tax accounting records, it should be noted that uncontradicted evidence established that a $1 million reduction to worldwide income (as would result from a $1 million increase in depreciation) would result in only a $40 reduction in ultimate California tax dollars due from BBI ($1727 tax reduction for Barcal). Ex. BB; R 1556. Therefore, it cannot be presumed that use in this case of book depreciation as a reasonable approximation of tax accounting depreciation (R 1467-68) made any material difference in the Barclays taxpayers' taxes. Certainly such use, which perhaps led to a better result for Barclays than use of the exact tax accounting figures would have, did not deprive them of the depreciation benefit.

§ 1.805- 5(a)(4)(iv)(b). In complying with California tax law, which differs from federal law in many respects, both domestic-based and foreign-based businesses had to rely on reasonable approximations, for the costs of compliance without such reliance would have been prohibitive for domestic-based as well as foreign-based businesses. JA A-842 to A-843.

3. California requires the same information and taxes from every taxpayer, whether its unitary business is domestic-based or foreign-based; California's tax could not become unconstitutionally discriminatory because of different burdens imposed within federal tax law.

Although its dormant Commerce Clause analysis was not necessary, the California Court of Appeal reached the correct conclusion as to the discrimination element. It correctly noted that under California law both foreign-based and domestic-based unitary groups "are treated the same – they face the same tax rate and must furnish the same kind of information." PA D-10. The fact that domestic groups, but not foreign-based groups, might also have to supply the same type of information to comply with United States tax laws does not inject discrimination into the evenhanded California tax requirements. PA D-10 to D-11.

The Court of Appeal correctly relied upon this Court's recent decision in *Kraft General Foods* v. *Iowa Dept. of Revenue*, ___ U.S. ___, 112 S.Ct. 2365 (1992). In *Kraft* this Court held that an Iowa tax law discriminated against foreign commerce because "Iowa imposes a burden on foreign subsidiaries that it does not impose on domestic subsidiaries." *Id.* at 2371 (footnote omitted). This Court also noted that if a state's tax system "does not favor business activity in the United States generally over business activity abroad[,] . . . this would indeed suggest that the statute does not discriminate against foreign commerce." *Id.* at 2370. As recognized by the California Court of Appeal, California applies exactly the *same* tax and information requirements to all businesses,

whether they have foreign connections or solely domestic connections. The fact that the Barclays group does not have to meet certain United States *federal* tax accounting requirements which domestic groups must fulfill separately from the California requirements does not render California's law discriminatory as to members of the Barclays group. See *Cotton Petroleum Corp.* v. *New Mexico,* 490 U.S. 163, 189 (1989), where this Court held that New Mexico's taxes were not unconstitutionally discriminatory:

> "The burdensome consequence is entirely attributable to the fact that the [taxable activities] are located in an area where two governmental entities share jurisdiction. . . . . [T]he New Mexico taxes are administered in an evenhanded manner and are imposed at a uniform rate throughout the State. . . . "[29]

In sum, the Barclays taxpayers have decided to do business in a jurisdiction which evenhandedly imposes the same tax and compliance burdens on *all* corporate taxpayers. As noted by the Court of Appeal:

> "[A] foreign-based multijurisdictional enterprise, in complying with a particular jurisdiction's taxation scheme, must always present its tax information in the language, currency and accounting principles the authorities in that jurisdiction understand. This does not constitute a *direct* commercial advantage to unitary groups based in that jurisdiction. At most, it constitutes an indirect cost inherent in doing business in *foreign* lands." PA D-10 (emphasis in original).

In any event, once it is determined that a state tax is not discriminatory on its face, the discrimination element of the dormant Commerce Clause analysis is satisfied if the tax is fairly apportioned. *Trinova Corp.* v. *Michigan Dept. of Treasury,* 498 U.S. 358, 385 (1991). In this case, consistent with

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[29] Compare *Fort Gratiot Sanitary Landfill, Inc.* v. *Michigan Dep't of Natural Resources,* ___ U.S. ___, 112 S.Ct. 2019 (1992) (Br.Pet. 45), where the statute drew a geographical line between categories of those who would be permitted to do a certain kind of business and those who would not be so permitted, and all out-of-state businesses were in the prohibited category.

this Court's holding in *Container* that the California tax system provides for fair apportionment of taxable income (463 U.S. at 180-84; see also above at pages 9, 33), the Barclays taxpayers have stipulated that they are not challenging the fairness of California's apportionment of income under WWCR. R 1551 (JA 832 to 833). Therefore, no discrimination is present for purposes of dormant Commerce Clause analysis.[30]

IV. THE DETERMINATION OF THE FOREIGN COMMERCE CLAUSE ISSUE IN THIS CASE PRECLUDES ANY FOREIGN AFFAIRS PREEMPTION ISSUE.

A foreign affairs preemption issue simply cannot be determinative in this foreign commerce context. An issue pertaining directly to the Foreign Commerce Clause is at the heart of the California Supreme Court's opinion. It is undisputed that the Constitution gives Congress alone the power "[t]o regulate commerce with foreign nations. . . . " U.S. Const. art. I, § 8(3). If, as the California Supreme Court has held, proper application of the *Wardair* rule in this case confirms that federal foreign commerce law contains permission for the states' use of WWCR, then no contrary foreign affairs aspirations of the Executive Branch could eclipse that permission. The Executive Branch's power in the field of foreign relations, " 'like every other governmental power, must be exercised in subordination to the applicable provisions of the Constitution.' " *Dames & Moore* v. *Regan,* 453 U.S. 654, 661 (1981), quoting *United States* v. *Curtiss-Wright Export Corp.,* 299 U.S. 304, 319-20 (1936).

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[30] Although it did not apply *Trinova,* the California Court of Appeal correctly distinguished the *Barclays* context from such cases as *Hunt* v. *Washington State Apple Advertising Comm'n,* 432 U.S. 333 (1977), on the basis that *Hunt,* with a facially neutral statute, involved more burdens than just compliance costs – in *Hunt* only out-of-state growers had to alter existing beneficial marketing practices – whereas *Barclays* involves only compliance costs in a context wherein foreign-based multinationals and domestic-based multinationals "must both furnish the same kind of information." PA D-11, n. 4.

But what of authorities such as *Hines* v. *Davidowitz*, 312 U.S. 52 (1941), and *Zschernig* v. *Miller*, 389 U.S. 429 (1968)? Barclays relies on these cases as barring any state act which has a direct impact upon foreign relations and which may adversely affect the power of the central government to deal with foreign affairs issues. The answer in this case must be given in the context of foreign commerce. If Congress has acted to permit state action in a foreign commerce context, no further authorization is needed, even though foreign relations are necessarily also involved. See *Wardair*, 477 U.S. at 12-13; see also *United States* v. *Guy W. Capps, Inc.*, 204 F.2d 655 (4th Cir. 1953), *aff'd on other grds.*, 348 U.S. 296 (1955).

Alternatively, in a dormant Foreign Commerce Clause context where no congressional acquiescence or prohibition is present, the *Container* decision teaches that a state tax at variance with the federal tax approach and affecting foreign commerce will violate the Foreign Commerce Clause if it " 'may impair federal uniformity in an area where federal uniformity is essential' . . . and 'prevents the Federal Government from "speaking with one voice" in international trade. . . . ' " 463 U.S. at 193. In reaching its Foreign Commerce Clause holding, *Container* contains many references to "foreign affairs," "foreign relations," and "foreign policy" (see 463 U.S. at 189, 194, 195, 196, 197); it rejected the dissent's position that California's application of WWCR was "an intrusion on national policy in foreign affairs that is not permitted by the Constitution." 463 U.S. at 206 (dissent). Thus, under *Container*, a dormant Foreign Commerce Clause holding in favor of WWCR includes consideration and determination of foreign affairs issues, leaving no room for any determination that the federal government's foreign affairs powers bar the application of WWCR to that taxpayer. This is consistent with the rule that the Congress and the President share authority over foreign affairs. See *Container*, 463 U.S. at 196; *Zschernig* v. *Miller*, 389 U.S. 429, 432 (1968). If a state tax affecting foreign commerce is valid either by way of congressional authorization or under the dormant Foreign Commerce Clause tests (which include the balancing of foreign policy considerations), it cannot be unconstitutional on the basis of infringement upon foreign affairs.

This Court cannot construe Executive Branch foreign policy aspirations as authoritative federal policy without disabling not only Congress but also the Constitution, which requires that treaties can become law only upon ratification by two-thirds vote of the Senate. U.S. Const. art. II, § 2 (Opp. Pet. App. A). By rejecting the Executive Branch's 1970's aspirations which were given voice in proposed article 9(4) of the US/UK Treaty, Congress' implied acquiescence in state use of WWCR has become a part of the "supreme law of the land" (U.S. Const. art. VI(2)). That law cannot now be voided merely by relabeling the Executive Branch's thwarted aspirations as "foreign policy."

V. CALIFORNIA'S APPLICATION OF WORLDWIDE COMBINED REPORTING TO THE BARCLAYS TAXPAYERS DID NOT VIOLATE DUE PROCESS.

After holding that Congress had exercised its Commerce Clause powers to permit California's use of WWCR, and having thus determined that no dormant Commerce Clause analysis could alter that permission, the California Supreme Court remanded the case to the California Court of Appeal for determination of the due process issues. PA C-38 to C-39. The Court of Appeal then confirmed that California law provides for (1) the avoidance of oppressive costs of compliance through the use of reasonable approximations and the principle of materiality (PA D-13 to D-14, D-20 to D-21, D-23 to D-24) (see discussion above at pp. 40-41) and (2) full judicial review of any claimed abuses of discretion by the taxing agency in the application of this procedure (PA D-21, D-23). On the basis of its construction of California law, the Court of Appeal held that there was no violation of due process in this case. PA D-27. The California Supreme Court denied Barclays' petition for review of this construction and holding. PA

E-1. Only the due process holding, not the state law construction, is properly before this Court for review. See above at pp. 40-41.

Barclays claims that the test of "reasonable approximations" provides "no standard to determine what 'approximations' will be accepted." Br.Pet. 49 (footnote omitted). Given the California court's carefully circumscribed construction of regulation 25137-6 (PA App. J),[31] given this Court's established use of the standard of "reasonable" as providing sufficient and appropriate guidance in the due process area,[32] and given the total lack of any showing by taxpayers that there was any abuse of discretion in the final administrative result in this case, Barclays' due process argument necessarily fails on the merits.

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31 "[T]he Board must consider the cost and effort of producing WWCR information in deciding whether to accept reasonable approximations, and that consideration is to use regularly-maintained or other readily-accessible corporate documents as the cost guideline." PA D-21. "[T]he Board's discretion regarding reasonable approximations is circumscribed and guided by our interpretation of section 25137-6(e)(1)'s mandatory consideration of cost and effort." PA D-23.

32 Barclays cites *Grayned* v. *City of Rockford*, 408 U.S. 104, 108 (1972), as its primary authority for what constitutes unconstitutional vagueness, without recognizing that *Grayned* itself uses "reasonable" as a standard: *Grayned* requires that a law give "reasonable opportunity to know what is prohibited." *Id.* Also, due process nexus requirements for taxation recently have been set in terms of what is "reasonable." *Quill Corporation* v. *North Dakota*, ___ U.S. ___, 112 S.Ct. 1904, 1910 (1992). The Fourth Amendment of the Constitution itself protects against "unreasonable" searches and seizures, and due process requires that a criminal guilt be proven beyond a "reasonable" doubt (*Austin* v. *United States*, ___ U.S. ___, 113 S.Ct. 2801, 2804-05 n.4 (1993)). Determinations by reference to "a standard of 'reasonableness' [are] not unusual under federal income tax laws" (*United States* v. *Ragen*, 314 U.S. 513, 522-24 (1942)), and Barclays' expert witness established that federal application of separate accounting involves administrative determinations of what constitutes a "reasonable approximation" (R 1270; JA 829). As to judicial review, this Court has long recognized that whether an action taken is "reasonable" is an "everyday subject[] of inquiry by courts in framing and enforcing their decrees." *Virginian Ry.* v. *Federation*, 300 U.S. 515, 550 (1937).

CONCLUSION

For the reasons given above, it is respectfully submitted that the California decision should be affirmed.

Dated: January 19, 1994.

Respectfully submitted,

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APPENDIX A

ARTICLE 9, PARAGRAPHS (4) AND (5) OF UNITED STATES/UNITED KINGDOM INCOME TAX TREATY AS ORIGINALLY NEGOTIATED BY EXECUTIVE BRANCH IN 1975 AND PRESENTED TO THE SENATE IN 1976

Article 9

Associated Enterprises

. . . .

(4) Except as specifically provided in this Article, in determining the tax liability of an enterprise doing business in a Contracting State, or in a political subdivision or local authority of a Contracting State, such Contracting State, political subdivision, or local authority shall not take into account the income, deductions, receipts, or outgoings of a related enterprise of the other Contracting State or of an enterprise of any third State related to an enterprise of the other Contracting State.

(5) For the purposes of this Convention, an enterprise is related to another enterprise if either enterprise directly or indirectly controls the other, or if any third person or persons (related to each other or acting together) control both.

[31 United States Treaties 5668, 5677]

(45)

No. 92-1384

In the Supreme Court
OF THE
United States

OCTOBER TERM, 1993

BARCLAYS BANK PLC,
Petitioner,

VS.

FRANCHISE TAX BOARD,
AN AGENCY OF THE STATE OF CALIFORNIA,
Respondent.

On Writ of Certiorari to the Court of Appeal of the State of California in and for the Third Appellate District

REPLY BRIEF FOR PETITIONER

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REPLY BRIEF FOR PETITIONER

I. INTRODUCTION[1]

California and its amici do not — and cannot — seriously dispute that (1) for over twenty years, California has taxed foreign multinationals utilizing a method inconsistent with the international standard; (2) use of this inconsistent method has deeply offended all of the major trading partners of the United States and resulted in threats of, as well as actual, retaliatory action; (3) through five Administrations (Republican and Democratic alike) this disruption of foreign economic policy has caused the Executive to express strong opposition to California's approach; (4) this opposition has included filing of amicus briefs by the United States in support of Barclays throughout the entire time this case was pending in the California courts and in Barclays' initial petition for certiorari in this Court; (5) these amicus briefs asserted that California's application of worldwide combined reporting ("WWCR") to Barclays was patently unconstitutional in the context of this very case; and (6) the current Administration's shift to a position supporting California in this case came only as a result of an avowed election-year accommodation,[2] and

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[1] There have been no changes to the Rule 29.1 Statement in this case since the Petitioner's Opening Brief ("Pet. Br.") was filed with this Court.

[2] The California Legislature's Committee Report described the accommodation as follows:

> The prior Administration had filed a brief with the Supreme Court on behalf of Barclays. But as a presidential candidate, Clinton assured California officials that he would side with the states on the issue.
>
> The threat of retaliation, however, naturally caused a seriously awkward situation for the new Administration, and Treasury representatives have requested that California's law be modified to remove the threat. California officials have been assured that if our law is changed in a manner which will remove the threat, then a neutral brief (to the effect that the Administration does not advise the Court to take up the *Barclays* case) would be filed.

PSA (1) L at A-25 (All references herein to Appendices are as defined in Pet. Br. at n. 1).

only after California agreed in its 1993 legislation to provide putative relief from WWCR on a prospective basis.

Nevertheless, California asserts that it was (and is) entitled to disregard the international standard unless and until Congress stops it from doing so. California's position is inconsistent with over one hundred years of this Court's foreign Commerce Clause jurisprudence and, in critical respects, even with the position of the current Administration.

California first attempts to evoke this Court's sympathies by asserting that "the fiscal security of the State of California is threatened" by Barclays' position. Resp. Br. at 4. California and other amici refer to potential revenue loss of $4 billion. *See, e.g., id.* at 2 n. 2. However, the amount at stake with respect to foreign multinational corporations (the issue in *Barclays*) is actually less than one-quarter of this amount, and the sum which the State would have to refund to foreign multinationals is even lower still ($500 million). PSA (1) L at A-22. These amounts would have been substantially smaller if California had taken timely action to achieve acceptable harmony with the international standard. Furthermore, last year, in the very legislation prospectively modifying California's WWCR method, the state granted tax relief to *California* business in the amount of $2.3 billion, an amount far exceeding the amount at issue here. PSA (1) L at A-22. In short, the amount at issue in *Barclays*, while large in absolute dollar terms, certainly does not threaten the fiscal security of California.

Moreover, California has been on clear notice from the outset that its application of WWCR to foreign multinational corporations was inconsistent with the international standard and was causing international offense. Ex 46J; R 1381. California chose to go forward with its taxing method with full knowledge of the risk it was taking, and must now bear the constitutional consequences of its actions.

California next relies on the California Supreme Court's view that this Court "re-oriented" its dormant foreign Commerce Clause analysis in *Wardair Canada Inc. v. Florida Dep't of Revenue*, 477 U.S. 1 (1986), so that congressional *inaction* can now be sufficient to remove a state tax from the reach of the Clause. Resp. Br. at 12-27. In particular, California argues that a

congressional "refusal" to act while "aware" of the "problem" is a satisfactory equivalent to the affirmative framing legislation in *Wardair*. As evidence of such refusal to act here, California relies primarily on three matters which this Court already determined in *Container Corp. of Am. v. Franchise Tax Bd.*, 463 U.S. 159, 196-97 (1983), do not evidence preempting congressional policy one way or another — failure of Congress to enact various bills affecting state taxation; declination of the Senate to ratify the United States/United Kingdom Income Tax Treaty ("US/UK Treaty") with a provision limiting states' use of WWCR (Article 9(4)); and general failure of United States tax treaties to cover state taxes other than in nondiscrimination clauses. This Court was right in *Container*. These matters do not establish any preempting congressional policy.

The United States agrees. U.S. Am. Br., No. 92-1384 and 92-1839 ("U.S. Br.") at 18. The United States does not see *Wardair* as a diminution of this Court's sensitivity to foreign commerce and continues to acknowledge that application of WWCR to foreign multinationals becomes unconstitutional when its use is incompatible with the international standard to which the United States adheres. U.S. Br. at 16 n. 10, 22. However, the current Administration now contends that in 1977, which it incorrectly identifies as the year of accrual of the tax in this case, such incompatibility did not yet exist because (in its view) the Executive Branch pronouncements as of that date were not sufficiently clear. U.S. Br. at 20.

The current Administration's analysis is unfortunately flawed both factually and legally. Both the record and other actions by the United States indicate clearly that the United States perceived WWCR as interfering with foreign policy by the very fact of its application to foreign multinational enterprises and had determined that the only resolution of such interference was conformity with the international standard. Focus only on the year of accrual is also incorrect legally since the interference occurs at the moment of application of the incompatible policy, and the clearest foreign implication, the threat that the use of such incompatible system will lead to foreign offense and eventual

retaliation, is, as this case amply demonstrates, inherent at time of accrual.

Finally, both California and the United States attempt to use California's prospective change in its legislation, but in quite different ways, to avoid a ruling in Barclays' favor. California contends that the foreign commerce violation should be tested not on the California law as it stood at the time of the tax, but on California's 1993 law even though it does not apply to past years. California argues that any concern over uniformity is now resolved and no nation can now justifiably retaliate. Resp. Br. at 35-37. The simple answer is that prospective legislation cannot cure past unconstitutionality: the violation already has occurred.

The United States, on the other hand, asks what California does not and never has—that Barclays not receive a refund of its taxes, even if those taxes are held to be unconstitutional. This refund issue, presented neither below nor to this Court by the parties, is not properly before the Court and should not be addressed. In any event, as the United States candidly acknowledges, its position flies in the face of this Court's decisions in *McKesson Corp. v. Division of Alcoholic Beverages & Tobacco*, 496 U.S. 18 (1990), and *Harper v. Virginia Dep't of Taxation*, ____ U.S. ____, 113 S. Ct. 2510 (1993), which hold squarely to the contrary.

II. RESPONDENT'S *WARDAIR* ANALOGY IS FLAWED. THIS CASE SHOULD BE MEASURED BY THE STANDARDS OF *JAPAN LINE* AND *CONTAINER*.

California ignores this Court's unbroken line of authority requiring clear and unambiguous congressional action to remove a state law from the reach of the dormant Commerce Clause. *See* Pet. Br. at 36-39. California's reliance on *Wardair* for such removal is incorrect.

A. The California Supreme Court's New Test for Preempting Congressional Policy Is Not Rooted in *Wardair*.

The California Supreme Court misread *Wardair*. *Wardair* depended upon affirmative legislation resolving a problem in part and a subsequent course of conduct between the United States

and other nations consistent with the resolution. *See* Pet. Br. at 35-36.

California does not, because it cannot, point to any framing legislation specifically addressing the issue in this case — the application of WWCR to foreign multinational enterprises. In this case there is no congressional enactment that gives any sense of congressional policy on the use of WWCR—in whole or in part, domestically or internationally—and certainly not a "preempting" policy to remove all state taxation from dormant Commerce Clause consideration.

B. California's "Evidences" of Preempting Congressional Policy Do Not Withstand Scrutiny.

As this Court found in *Container*, 463 U.S. at 196-97, the evidence cited by California does not, separately or collectively, establish such preempting policy.

1. The Reservation of Article 9(4) in the US/UK Treaty Does Not Evidence Affirmative Permission for State Use of WWCR.

Barclays agrees that the US/UK Treaty Hearings constituted Senate consideration of the issue in this case. In the absence of conclusive action, however, California seeks to draw from the stalemate created by a minority of the Senate an "implication" that the eventual ratification by the Senate of the Treaty, with Article 9(4) reserved, constituted affirmative congressional permission for states to apply WWCR to foreign multinational enterprises. Resp. Br. at 20-23.[3]

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[3] Some amici quote language in the Senate Foreign Relations Committee Report on the Third Protocol out of context to conclude that states "are free to use formula methods." JA-422. Such conclusion is incorrect. The Committee Report on the Third Protocol states flatly that Congress has not taken "a position on the merits of the issue." JA-424. *Garcia v. San Antonio Metro. Transit Auth.*, 469 U.S. 528 (1985), is not on point. That case involved the power of Congress over the states in interstate commerce, not the role of the Senate in treaties. As this Court stated in *Japan Line, Ltd. v. County of Los Angeles*, 441 U.S. 434, 448

A majority of the Senate twice voted to limit state use of WWCR (by voting against the reservation and then for the Treaty with Article 9(4)). California and its amici (except the United States) conspicuously omit any reference to the truly focused vote on this issue: the reservation. If the Senate wanted to permit state use of WWCR, it could have voted *for* the reservation. Instead a majority of the Senate voted *against* the reservation. JA-390 to 94.

The policy choice in the Senate was not between (i) having the Treaty at all and (ii) letting states use WWCR. Rather the choice was one of method, i.e., whether or not to use the treaty route.[4]

Finally, the California Supreme Court, searching for *Wardair* parallels, described the US/UK Treaty as a "policy choice" by the two contracting parties. PA C-30. Both the United States (U.S. Br. at 23-24) and the United Kingdom (U.K. Br. at 7-8) have informed this Court to the contrary. The actions of both parties subsequent to the Treaty enactment confirm this. *See* JA-785 to 786; PA A-18 to 20, A-21 to 22.

2. Congress Has Not "Refused to Act" on Legislation Involving This Issue.

California characterizes the introduction of a string of unfocused bills dealing with a myriad of state tax issues as evidence of congressional "awareness" of the problem in this case, and inaction on these as "refusal to act." Resp. Br. at 18-20. Congress acts by voting. There has never been a vote on any of these bills. PA A-31 to 32; R 228 to 29; Ex 37C at 89. Without a vote on a specific bill, it is not possible for this Court to discern what, if any, policy Congress is allegedly adopting by not acting. For example, here amici contend that by not acting on the various bills Congress adopted a policy of letting states tax as they please.

n. 13 (1979), Congress' power to regulate foreign commerce is not restricted by considerations of federalism and state sovereignty.

[4] As the record amply demonstrates, the United States and its trading partners turned to other means to resolve the problem, including this litigation. *See, e.g.*, JA-786.

Bills introduced prior to 1972, when California first extended WWCR to foreign enterprises, cannot show congressional awareness of a problem that did not exist.[5] Bills introduced subsequently concern a number of issues, including the application of WWCR to domestic multinational entities, and in 1983 this Court in *Container* held that such bills evidenced no congressional policy as to state use of WWCR. *Container*, 463 U.S. at 196-97.[6]

Further, other events occurring at or around the time of the introduction of bills can explain Congress' failure to take action. In 1983 this Court expressly reserved the issue in this case in *Container*. The members of Congress were clearly aware of this decision as well as the Court's 1979 decision in *Japan Line*. JA-424 to 426; Ex 37H at 22-47; Ex 37F at 12, 16. Congress did not need to act in light of that case law and pendency of this action.

3. Treaty Failure to Cover State Taxes Is Not Partial Action.

California argues that the exception of state taxes from coverage under United States treaties, other than in the nondiscrimination clauses, may be seen as "partial" congressional action. California's analogy to *Wardair* is unfounded.

California cannot contend with any candor that treaty negotiators were making a policy choice to deal with some state tax problems and not others. The nondiscrimination clauses are just

[5] Although Senator Church offhandedly asserted that Congress had been facing the issue for ten years (JA-252), Assistant Secretary of the Treasury (Policy) Woodworth testified in 1977 that to his knowledge Congress had not been presented with legislation on the question. Ex. 37C at 89.

[6] *Bob Jones Univ. v. United States*, 461 U.S. 574 (1983) does not support California. As this Court pointed out, evidence of congressional approval of the IRS policy in the ruling went "well beyond" the failure of Congress to act on the bills: tax legislation enacted subsequent to the ruling, committee reports specifically approving the federal court decision underlying the IRS ruling and consistency of the ruling with legislation, policies and decisions of all three branches of government. *Id.* at 601.

too general: the clauses are considered nonsubstantive, not all tax treaties contain them (although all treaties of friendship, commerce and navigation which are general treaties do) and the clauses only apply to foreign entities not to their domestic subsidiaries.[7] *See* Ex. 37C at 29; R 1808-09, 1811-12; *see also* *Sumitomo Shoji America, Inc. v. Avagliano*, 457 U.S. 176 (1987).

California's contention that treaty negotiators were aware of the potential application of WWCR and hence negotiated clauses with WWCR in mind cannot be taken seriously. That California at some time began to apply WWCR to some domestic multinational enterprises does not give any indication that California would, in defiance of the international norm, suddenly extend its incompatible method to foreign multinational enterprises.[8]

III. WWCR IS UNCONSTITUTIONAL UNDER THE DORMANT COMMERCE CLAUSE.

Prior to the current Administration's election-year accommodation, the United States repeatedly took the position that WWCR, as applied in the context of this very case, patently violated the dormant foreign Commerce Clause. The United States has been right all these years. If anything, passage of the 1993 California legislation underscores the incompatibility be-

[7]California incorrectly characterizes the withdrawal by BBI of an issue concerning discrimination against BBI (not Barcal) under the US/UK Treaty. Resp. Br. at 16 n. 11. The issue was one of treaty interpretation, not constitutionality. See BBI Complaint, ¶ 15.

[8]California's reliance on *Bass, Ratcliffe & Gretton, Ltd. v. State Tax Commission*, 266 U.S. 271 (1924), decided prior to the creation of the international norm, prior to modern Commerce Clause jurisprudence and well prior to the invention of WWCR is misplaced. This Court referred to *Bass Ratcliffe* three times in *Container* (463 U.S. at 164-66), but reserved the question of the constitutionality of WWCR as applied to foreign based groups. The League of Nations specifically rejected formulary apportionment as the basic concept and selected the arm's length separate accounting method ("ALSA") in 1933. None of the cases cited in Resp. Br. at 17 n. 12 involves WWCR and *Butler Bros. v. McColgan*, 315 U.S. 501 (1942) does not even involve combined reporting.

tween WWCR and the international standard; certainly, this prospective legislation does not cure the past unconstitutionality. California's and the current Administration's efforts to defend the previous system, based on subsequent events and reinterpretation of history, do not withstand analysis.

A. Uniformity Is Essential In This Sensitive Area.

California first argues that WWCR does not interfere with essential uniformity because Congress would have legislated uniformity before now if it was essential. Resp. Br. at 29. California's attempt to recast its *Wardair* argument in terms of dormant Commerce Clause analysis is no more successful here. It ignores the self-executing nature of the Commerce Clause and this Court's traditional role in preserving federal uniformity in the *absence* of congressional legislation, as recognized in *Wardair* itself: "it is the responsibility of the judiciary to determine whether action taken by state or local authorities unduly threatens the values the Commerce Clause was intended to serve." *Wardair*, 477 U.S. at 7. The need for uniformity, and this Court's role in preserving uniformity, is particularly pronounced with respect to foreign commerce in light of the overriding national interests involved. *See, e.g., Japan Line*, 441 U.S. at 446-48. The United States agrees. U.S. Br. at 16.

California next invites this Court to ignore over 20 years of unconstitutionally collected taxes because California has *now* allegedly moved into "acceptable harmony" with the international standard.[9] Resp. Br. at 29-32. Essentially, California's argument is that the state is free to collect an unconstitutional tax for more than 20 years, push the nation to the brink of a trade war and, because it finally yields to a combination of threats and promises in the hope of avoiding a decision by this Court (PSA (1) L at A-24 to 25), keep the spoils. California attempts to justify this post hoc approach on the basis of protecting "settled expectations."

[9]Barclays continues to contend that California's new legislation is not in full conformity with the international norm for the reasons previously stated. Pet. Br. at 42.; Supplemental Brief of Petitioner at 6-7.

Resp. Br. at 32. It is Barclays' position, however, and not California's, which rests on settled expectations:

• There is the presumptive need for uniformity in foreign commerce, and well-established tests of this Court to measure that need, *i.e.*, "multiple taxation" and "one voice." *See Japan Line*, 441 U.S. at 451; *Container*, 463 U.S. at 186-87; *Wardair*, 477 U.S. at 8; *Kraft General Foods, Inc. v. Iowa Dep't of Revenue and Fin.*, ____ U.S. ____, 112 S. Ct. 2365, 2370 (1992); *Itel Containers Int'l Corp. v. Huddleston*, ____ U.S. ____, 113 S. Ct. 1095, 1103 (1993). The need for the nation to speak with one voice stretches from the adoption of the Constitution. *See* Federalist Paper No. 42 (Madison). This Court has long recognized the sensitive nature of foreign commerce and foreign affairs because of the potential harm to the nation as a whole. *See, e.g., Brown v. Maryland*, 25 U.S. (12 Wheat.) 419, 445-47 (1827); *Chy Lung v. Freeman*, 92 U.S. 275, 279-80 (1875); *Kraft*, 112 S. Ct. at 2370; *Wardair*, 477 U.S. at 8.

• ALSA is the international norm that has attained the status of a custom of nations. PA A-20; JA-823. The United States has been a leader in efforts to establish that standard since the 1930s. JA-821 to 23. Congress has resisted numerous efforts to change the use of this ALSA standard.[10] Use of this single standard has engendered "reliance interests" of sixty years' duration. JA-822.

• According to California and the United States, California will no longer be relying on WWCR as its basic system. Resp. Br. at 35-36; U.S. Br. at 28. In the interim, California has been well aware of opposition to its use of WWCR in these circumstances, both by the United States and by its foreign trading partners (and even by some other states and state tax groups[11]), and has nevertheless chosen to proceed. That has upset the status quo.

---

[10] *See, e.g.*, H.R. Rep. No. 1447, 87th Cong., 2d Sess., 28-30 (1962); Ex. 49A; Statement of Fred T. Goldberg, Treasury Assistant Secretary (Tax Policy), at the July 21, 1992 House Ways and Means Committee Hearing on H.R. 5270, "The Foreign Income Tax Rationalization and Simplification Act of 1992."

[11] U.S. Br. at 5; JA-579; Ex. 66A.

The demands of the nation's economy do require stability. *Allied-Signal, Inc. v. Director, Div. of Taxation*, ____ U.S. ____, 112 S. Ct. 2251, 2262 (1992). But stability in the global market is conformity to the international standard. States remain free to use formulary apportionment and combined reporting within U.S. boundaries.[12]

B. Foreign Retaliation Was and Is Justifiable.

The clearest implication of foreign policy is the threat that the aberrant state tax will offend trading partners and lead to retaliation. *Container*, 463 U.S. at 194. There is no doubt that offense and retaliation have occurred here — indeed, few issues have provoked as broad and intense a reaction from foreign nations. *See, e.g.*, JA-576. California argues, however, that these reactions have been unjustified. California is wrong.

First, the United States itself has confirmed that our trading partners' criticisms of WWCR have been "sound." JA-576.[13]

---

[12] This case does not involve questions of federalism or the sovereign rights of the states. There are no states outside the United States and "[g]overnmental power over external affairs is not distributed but is vested exclusively in the national government." *United States v. Belmont*, 301 U.S. 324, 330, 331-32 (1937). Although many amici in support of California make it clear that they consider the underlying issue to be the freedom of the states to experiment with ways to divide or otherwise capture foreign international income until Congress tells them to stop (*see Japan Line*, 441 U.S. at 454), that is not a prerogative of the states' beyond the nation's borders. The states' reach cannot exceed the grasp of their sovereign, the national government.

[13] California and various amici spend several pages praising formulary apportionment and condemning the arm's length standard. However, that is not the issue in this case. In both *Container* and *Japan Line*, this Court made it quite clear that it must proceed to analysis under the additional foreign Commerce Clause tests even if the Court might prefer or even require domestic formula apportionment. *Container*, 463 U.S. at 185, 193; *Japan Line*, 441 U.S. at 445-46. Contrary to California's contention (Resp. Br. at 3), Barclays' agreement not to raise a fair apportionment challenge to the three factor formula (one of the four *Complete Auto* domestic tests) is in no way a concession regarding any

Application of WWCR in the international context clearly has produced results and burdens which, even if *de minimis* in the interstate context, have caused justifiable offense to every major trading partner of the United States.

Second, California contends that the United Kingdom had no right to retaliate because it allegedly bargained away any rights in accepting concessions in the US/UK Treaty. Resp. Br. at 35. No such bargain occurred: the United Kingdom has made it clear, both at the time of its own ratification of the treaty and subsequently, that it expected resolution of the WWCR issue.[14] And many other nations, not just the UK, have threatened retaliation or taken retaliatory steps. *See, e.g.*, PSA (1) O at A-34 to 35; R 94, 1157; Ex. 46H. Moreover, the United States also made it crystal clear to the states that their use of WWCR was the *cause* of the conflict. JA-601 to 03.

Third, California argues that retaliation is *now* unjustifiable because California has moved away from its interfering system. Resp. Br. at 36. Again, this is an admission that the prior California system caused international implications. California is asking this Court to look only at its newly compatible system, which is not before this Court, and not the incompatible system in place when the taxes were levied. California's approach would eviscerate the "speaking with one voice" test by allowing offense and retaliation to go on for years, only to have a state avoid a holding of unconstitutionality by prospectively changing its law on the eve of argument.

of the other *Complete Auto* tests or the additional *Japan Line* tests, including the justifiability of foreign retaliation. *See Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274 (1977).

[14]*See, e.g.*, JA-71, 149-50, 424. The alleged concessions were actually mutually beneficial provisions. JA-434, 437. Whether UK retaliatory legislation would be a violation of the Treaty is, as the United States responded to that same argument by California below, a matter to be addressed by the Federal Executive, not the State. PA H-41 n. 18.

C. WWCR Creates Multiple Taxation.

California is incorrect in contending that Barclays did not establish multiple taxation. Resp. Br. at 39. The trial court held to the contrary. PA A-25.

California further ignores the fact that the problem of multiple taxation is different in the foreign than in the domestic context. As the United States points out, a level of multiple tax acceptable with respect to domestic corporations may, when applied to foreign entities, still trigger complaints or retaliation from foreign governments and thus disrupt foreign commercial policy. U.S. Br. at 24-25 n. 18. Here, the application of the incompatible WWCR system to foreign multinationals has created a risk of multiple taxation that is irreconcilable and fundamentally different than the risk this Court posited in *Container* with respect to domestic corporations.

D. The Current Administration Errs Legally and Factually in Its Focus on The Year of Tax Accrual.

The current Administration concedes, in accordance with the United States' position throughout this litigation, "that a state tax violates the Foreign Commerce Clause if it is incompatible with an international standard to which the United States has committed itself by general agreement with its trading partners." U.S. Br. at 22. The current Administration departs from prior Administrations, however, in arguing that (1) "[t]o establish a constitutional violation . . . petitioner must show that the incompatibility existed prior to the accrual of the disputed tax liability" (*id.*), and (2) such incompatibility (in this Administration's view) did not exist prior to 1977, which it asserts to be the year of tax accrual here.[15]

This new position is particularly convenient: it allows the Administration to support California in this case in accordance

[15]As California correctly recognizes (Resp. Br. at 2), the tax year (the year of accrual) in this case actually is 1978, not 1977 (the "income year"). In the 1970s, a California taxpayer paid a franchise tax for the tax year based on the preceding year's income. Cal. Rev. & Tax. Code § 23151(a).

with its pledge, while effectively conceding that California's WWCR system (as applied to foreign multinationals) became unconstitutional at some date subsequent to the tax year at issue here and continued to be unconstitutional at least until the 1993 legislation. This position avoids the issue in this case, but guarantees further litigation regarding the subsequent tax years. More importantly, it is fundamentally wrong. The Administration's focus on the year of accrual is wrong as a matter of law, but even under the Administration's own test, a correct reading of the facts demonstrates that unconstitutionality existed as of the year of accrual here.

1. Focus on the Year of Accrual Is Legally Incorrect.

The Administration's test is wrong for at least the following reasons:

a. As applied in the Administration's Brief, the test focuses on the *timing* of Executive pronouncements, rather than the underlying *incompatibility* between WWCR and the international standard. Under *Container*, a state tax at variance with federal policy, which WWCR clearly is, violates the one voice standard if it *either* (1) implicates foreign policy issues which must be left to the federal government *or* (2) violates a clear federal directive. *Container*, 463 U.S. at 194. The Administration's approach confuses the second test with the first. Under the first test, the "clearest foreign policy implication" is the threat of retaliation (*id.*), which is not tied to the timing of the Executive's directives. Rather, it follows from the incompatibility of WWCR with the international standard. Incompatibility exists at the moment of application; it is inherent in the use of two different systems.

b. The Administration cites no authority for its test, and it is contrary to controlling authority of this Court. *See, e.g.*, *Japan Line*, 441 U.S. at 453 (concern of this Court over threats of retaliation in 1978 where tax years are 1970, 1971 and 1972). The Administration's test is also contrary to common sense: it puts pressure on foreign nations to retaliate immediately to establish clear "incompatibility" or else the state gets a free ride for a number of years while the problem escalates. The potential for harm to the nation as a whole is apparent.

c. The Administration's test also ignores the lengthy nature of California's audit and dispute resolution cycle, which creates foreign offense long after the year of tax accrual. Any reasonable approach must assess the foreign policy implications, and the incompatibility with the international standard over this entire period, not merely the year of tax accrual.[16]

2. The Current Administration Is Factually Incorrect.

The current Administration candidly acknowledges that its views regarding the status of Executive policy in 1977 are not entitled to great deference: "A brief filed by the government in 1994 provides a clear indication of current executive branch policy. It is not entitled to the same weight, however, in determining what policy was in place in 1977." U.S. Br. at 21. In fact, the courts below found — contrary to this Administration's view — an Executive policy that WWCR was incompatible with the international standard as of the time period at issue here:

a. The trial court found:

> [T]he evidence shows unequivocally that the Executive branch all along, under three administrations since the WWCR problem in the present context became known [1972], has steadfastly adhered to a policy of use of the arms length/separate accounting (AL/SA) method and not WWCR, both as to the States and the Federal Government.

PA A-19 (bracketed material added). *See also* the California Court of Appeal's First Opinion, PA B-29 to 31 (affirming findings of trial court).

b. This finding is fully supported by the record, which is replete with evidence of the foreign policy implications from the early 1970's on, when California first applied WWCR to foreign multinationals. *See, e.g.*, PA A-17, 21; JA-771; Ex. 37C at 33.

[16]Indeed, because California and the other states extended WWCR in the early 1970's by administrative fiat (Ex. 37C at 25; JA-57), the first time many foreign-owned taxpayers even learned of the California practice was when they were audited and assessed several years after the year of tax accrual. R 1380-81.

The Federal Executive immediately reacted to foreign complaints, reviewed them, determined that they were proper, and set out to limit states to use of the arm's length standard for division of foreign international income. JA-775 to 83. George Carlson, senior Treasury career official concerned with this problem from 1975 to 1986, testified that inclusion of Article 9(4) in the US/UK Treaty was a direct response by the United States to complaints of many foreign nations, not just the UK, and manifested the policy of the United States in *1975* to limit use of WWCR. JA-783; R 96-97.[17]

c. At the hearings before the Senate Foreign Relations Committee, Assistant Secretary of Treasury Woodworth testified that Article 9(4) was not simply a quid pro quo for other concessions by the British:

> We wouldn't have agreed to the treaty provision if we didn't think that it would make a good general rule.

Exhibit 37C at 22.

d. Assistant Secretary Woodworth also explained the policy considerations, namely that the Federal Government and "practically all of the rest of the world" used the arm's length procedure and, even if it were not the best, it was important that all used the same test. With differing systems, "even though one may be theoretically as good as the other," double taxation is possible. Thus, "it is desirable *per se* to have the same kind of method of taxing income, whether or not you can declare one method to be perfect and the other one not." Ex. 37C at 24.

e. Secretary Blumenthal's February 15, 1977 letter establishes WWCR's incompatibility with the international standard as of 1977. Among other things, that letter states that WWCR "is

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[17]The United States places great reliance on the Treasury response to California's claims of $125,000,000 of annual revenue loss. Ex. 37C at 304 to 306 cited at U.S. Br. at 4-5. Read as a whole, the response does not support the Administration's characterization. The statement quoted at U.S. Br. 5-6 (1977 Hearings 35) is simply the technical description of Article 9(4), i.e., how this provision works in the Treaty.

inconsistent with accepted tax treaty policy. . . ." (*See* U.S. Br. at 5, Ex. 46J.)

f. Finally, the United States repeatedly has taken the position, in numerous cases other than this one, that WWCR was unconstitutional with respect to the very tax year at issue here and even years prior to that. A list of such cases is attached as Appendix S hereto. Most pointedly, when its own money was at stake, the United States did not hesitate to take the position that WWCR was unconstitutional with respect to tax years 1976, 1977 and 1978. *See United States v. Alaska* (D. Alaska, No. 87-328 CIV). Excerpts from the record in that case are contained in Appendix T.

IV. WWCR AND ITS COMPLIANCE MECHANISMS DISCRIMINATE AGAINST FOREIGN COMMERCE.

In its opening brief, Barclays demonstrated that California's WWCR system unconstitutionally discriminates against foreign commerce: (a) literal compliance with California's WWCR reporting requirements imposes "prohibitive" administrative burdens on foreign multinationals, greater than those incurred by domestic taxpayers (Pet. Br. at 44-45); (b) this discriminatory *effect* is unconstitutional, notwithstanding the presumed facial neutrality of California's compliance system (*id.* at 45-46); and (c) California's regulation on filing of tax returns based on "reasonable approximations" does not cure this unconstitutionality; to the contrary, it results in deprivation of tax benefits — itself an unconstitutional discrimination against foreign commerce (*id.* at 47-48).[18]

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[18]As set forth in Barclays' opening brief (Pet. Br. at 48-49), California's system of filing based on approximations also violates due process. Contrary to California's argument (Resp. Br. at 47-48), in this sensitive area of taxation affecting foreign relations, "reasonableness" is hardly a sufficient standard for determining when the Board is required to accept approximations in lieu of literal compliance. *See* Pet. Br. at 49. As the trial court found, such a system constitutes taxation by "supplication and negotiation" and violates due process. PA A-29.

First, California argues that foreign taxpayers need not incur these prohibitive compliance burdens because the tax administrator has discretion under California's regulation to accept filings based on "reasonable approximations." However, discretion in an administrator not to discriminate does not cure the unconstitutionality. *Fort Gratiot Sanitary Landfill, Inc. v. Michigan Dep't of Natural Resources*, ____ U.S. ____, 112 S.Ct. 2019, 2025 (1992).

Second, California argues further that filing based on "reasonable approximations" does not result in denial of tax benefits. Resp. Br. at 40-43. This argument is directly contrary to the trial court's finding, which the Court of Appeal did not dispute, that filing based on "reasonable approximations" *does* result in denial of tax benefits (*e.g.*, California tax depreciation). *See* Pet. Br. at 47-48. This difference in tax benefits, arising solely because of activity outside the United States, in and of itself establishes unconstitutional discrimination against foreign multinationals. *New Energy Co. of Indiana v. Limbach*, 486 U.S. 269 (1988); *Kraft*, 112 S.Ct. at 2369-70, *see also* Brief for Banque Nationale De Paris as *Amicus Curiae* in Support of Petitioner at 1, 7-10; Brief *Amicus Curiae* on Behalf of Reuters Limited in Support of Petitioner Barclays Bank PLC at 6-9; Brief of the Confederation of British Industry as *Amicus Curiae* in Support of the Petitioner at 13-15.

Third, California asserts that its compliance requirements cannot be discriminatory because they are facially neutral (*i.e.*, California requires the same information from and applies the same tax rate to all taxpayers). Resp. Br. at 43-45. As set forth in Barclays' opening brief, however, this position is flatly contrary to well-established authorities of this Court that a discriminatory *effect* is unconstitutional even where there is facial neutrality. Pet. Br. at 45-47.[19]

[19]California cites *Trinova Corp. v. Michigan Dep't of Treasury*, 498 U.S. 358 (1991) (a domestic VAT case), for the proposition that the inquiry on unconstitutional discrimination of a facially neutral tax ends if it is fairly apportioned. However, in *Kraft*, 112 S.Ct. at 2370, this Court recognized that the prohibition against state taxation is broader in foreign commerce and a difference in burden, as here, even without local favoritism may create unconstitutional international implication.

V. THE REFUND ISSUE RAISED BY THE UNITED STATES IS NOT PROPERLY BEFORE THIS COURT.

In the almost ten years this case has been pending, California has never questioned Barclays' entitlement to a refund in the event of a final judgment in Barclays' favor. Accordingly, this issue was never briefed or addressed in any of the courts below; it was not presented as an issue in Barclays' petition for certiorari; and it has not been raised here by either of the parties to this case. Indeed, while expressly raising the issue of prospectivity in the consolidated *Colgate* case (No. 92-1839), California continues to concede (as it must) that the ruling sought by Barclays necessarily would apply retroactively. *See* Resp. Br. at 13 n.9.

Contrary to this Court's Rules 14.1(a), 24.1(a), 24.2 and 37.6, the United States as amicus now seeks to raise the refund issue for the first time. In accordance with the Rules, as well as California's expressed position, this Court should decline to address this issue.

Because the issue is not properly before this Court, Barclays will respond only briefly as follows (and respectfully requests the opportunity for further briefing should the Court decide to address the issue):

1. The United States itself concedes, "when a state tax is determined to have been unlawfully collected, the Constitution *requires* meaningful retrospective relief, ordinarily in the form of refunds." U.S. Br. at 22 (emphasis added), citing *Harper*, 113 S. Ct. at 2519-20; *McKesson*, 496 U.S. at 31, 39-41.

2. The constitutional issue raised by Barclays was expressly reserved by this Court in *Container*. Contrary to the United States' suggestion (U.S. Br. at 29), *Container* in no way supports denial of refunds here.

3. Refunds repeatedly have been recognized as the appropriate remedy for Commerce Clause violations, both where interstate commerce is involved (*see, e.g., Dennis v. Higgins*, 498 U.S. 439, 447 (1991)), and where foreign commerce is involved (*see,*

e.g., Japan Line, 441 U.S. at 437, 457). An unconstitutional burden on commerce injures the individual instrumentalities of such commerce as well as the overall interests of the United States. The Administration's position (U.S. Br. at 29) — that a foreign Commerce Clause violation causes cognizable injury only to the United States — is contrary to these authorities as well to *McKesson* and *Harper,* which require meaningful relief to the taxpayer as a matter of due process.

VI. CONCLUSION

For all the reasons set forth above and in Barclays' opening brief, this Court should rule in Barclays' favor.

Respectfully submitted,

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Appendix S

The United States has consistently taken the position in tax refund suits for tax years beginning as early as 1965, as well as in suits for declaratory and injunctive relief, that WWCR applied to foreign multinationals is unconstitutional.

See, for example:

- Memorandum for The United States as Amicus Curiae, "*Chicago Bridge & Iron Company v. Caterpillar Tractor Co,*" in the Supreme Court of The United States, No. 81-349, October Term 1981. [Tax Years 1970-1974.] Ex. 77C.

- Brief Amicus Curiae of The United States, "*Alcan Aluminium Ltd. v. Franchise Tax Board of the State of California,*" U.S. District Ct. Northern District of Ill., Civ. Action 84-C-6932 [Tax Years 1972, 1978 and 1979] coordinated with "*Imperial Chemical Industries, PLC v. Franchise Tax Board,*" U.S. District Ct. Northern District of Ill., Civ. Action 84-C-8906 [Tax Years 1972-1982] Ex. 77E.

- Brief Amicus Curiae of The United States in Support of Plaintiffs, "*Barclays Bank International Ltd., et al. v. Franchise Tax Board,*" Superior Court of the State of California in and for the County of Sacramento, No. 325059, coordinated with "*Barclays Bank of California v. Franchise Tax Board,*" Superior Court of the State of California in and for the County of Sacramento, No. 325061.

- "*United States v. State of Alaska, Hugh Malone, Commissioner of Revenue of the State of Alaska,* United States District Court In and For the District of Alaska, No. A87-328 Civ. [Tax Years 1976, 1977 and 1978.] Appendix T.

- Brief Amicus Curiae of The United States in Support of Plaintiffs and Respondents, "*Barclays Bank International Ltd. v. Franchise Tax Board,*" Court of Appeal of The State of California, Third Appellate District, No. 3 Civil C003388, coordinated with "*Barclays Bank of California v. Franchise Tax Board,*" Court of Appeal of The State of California, Third Appellate District, No. 3 Civil C003389.

- Brief Amicus Curiae of The United States in Support of Plaintiffs and Respondents, "*Barclays Bank International Ltd., et al. v. Franchise Tax Board,*" Supreme Court of The State of California, No. S019064 [PA H].
- Brief Amicus Curiae of the United States, "Alcan Aluminum Corporation v. Franchise Tax Board," Court of Appeal of the State of California, Second Appellate District, Division Three, No. B065648 [Tax Years 1965-1971].
- Brief for The United States as Amicus Curiae in Support of Petitioner, "*Barclays Bank PLC v. Franchise Tax Board, an Agency of The State of California,*" United States Supreme Court, No. 92-212, October Term, 1992 [Tax Year 1978] [PSA (1) K].

APPENDIX T

SUMMARY

In 1987 the United States filed suit against the State of Alaska in *United States v. Alaska* (D. Alaska, No. 87-328 CIV), initially seeking declaratory relief and an injunction in an amended complaint, and subsequently, in an amended complaint, return of taxes paid for the years 1976, 1977 and 1978. Alaska had computed the taxes of a United States contractor, a subsidiary of a Canadian parent, under its worldwide combined reporting system (which the United States described as identical to California's). The United States was liable for the taxes by contract. The suit was based on the same grounds of unconstitutionality as in this case (and in fact referred to this case), and the United States clearly affirmed its view that WWCR unconstitutionally interfered with the ability of the United States to conduct its foreign economic policy. Alaska settled the suit by making some repayments to the United States.

Excerpts From Pleadings In

UNITED STATES OF AMERICA,
Plaintiff

v.

STATE OF ALASKA; HUGH MALONE
Commissioner of Revenue of the State of Alaska,
Defendants

CIVIL ACTION NO. A87-328 CIV

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FILED
JUL 15 1987
UNITED STATES
DISTRICT COURT
DISTRICT OF
ALASKA
By /s/ ________ Deputy

IN THE UNITED STATES DISTRICT COURT FOR THE DISTRICT OF ALASKA

UNITED STATES OF AMERICA,
Plaintiff

v.

STATE OF ALASKA; HUGH MALONE,
Commissioner of Revenue of the State of Alaska,
Defendants

CIVIL ACTION NO. A87-328 CIV

COMPLAINT FOR DECLARATORY AND INJUNCTIVE RELIEF

The plaintiff, the United States of America, by and through its undersigned attorneys, complains and alleges as follows:

1. This is a civil action instituted by the United States for the purpose of obtaining (a) a declaratory judgment that imposition of Alaska's corporate income tax on a federal contractor on a worldwide unitary basis is unconstitutional, and that Alaska in applying the unitary tax formula in assessing its corporate income tax should not include reimbursement of payments to subcontractors in the sales factor, and should not include property of subcontractors and the United States in the property factor and alternatively that the proper basis for corporate income taxation by the State of Alaska of the federal contractor should be separate accounting, not unitization, and (b) preliminary and permanent injunctions restraining the defendants and those acting in concert with them from issuing further assessments or otherwise attempting to collect income taxes from the federal contractor except on the basis of the declaratory judgment.

2. This action is brought by the United States at the request of the Department of the Interior, at the direction of the Attorney General of the United States and has been brought to vindicate the sovereign rights and pecuniary interests of the United States.

* * *

[p.6] 16. Husky Oil Company and NPR filed Alaska corporate income tax returns and paid taxes for 1976, 1977 and 1978. The tax returns were based on a modified combined reporting system—certain companies were included in the unitary group and others were not. On December 15, 1981, the Alaska Department of Revenue issued an assessment adjusting the taxes for the years in question. Husky Oil Company and NPR were assessed additional taxes for the three years of $1,318,119, plus interest of $363,487 (computed to January 15, 1982), for a total of $1,681,678. The interest to date is about $1.3 million; the total tax plus interest now exceeds $2.6 million. Husky Oil and NPR appealed the assessment. After an informal conference decision against them, a formal hearing was held on April 24, 1985. A decision in large part affirming the assessment was issued on June 6, 1987, and adopted by the Alaska Commissioner of Revenue on June 9, 1987. The tax assessment as issued by the Alaska Department of Revenue and as affirmed by the Alaska Commissioner of Revenue was based on the premise that NPR was a member of a worldwide group of related corporations, the members of which were the Canadian parent corporation, Husky Oil Limited, and the various subsidiaries of that Canadian parent. Further, the assessment was based on the three-factor formula utilized in computing the tax of a member of a unitary group of corporations, and in the property factor of that formula the

defendants included property owned by the United States and the subcontractor mentioned above although NPR had no ownership, leasehold, bailment or right to use such property for any purposes of its own. Further, in the sales factor of the said formula the defendants included the payments made by the United States to the subcontractors through NPR although these payments did not represent any purchase proceeds paid to NPR on account of sales by NPR to the United States.

17. Any corporate income taxes assessed by the State of Alaska on NPR in connection with the Geological Survey contract would be, if paid by NPR, reimbursed from the funds of the United States in accordance with the provisions of 48 C.F.R. Part 31.205-41, which is incorporated by reference into the contract between NPR and the Geological Survey.

18. Imposition of Alaska corporate income tax on NPR on a worldwide basis violates the Foreign Commerce and Due Process Clauses of the United States Constitution. Alaska in applying the unitary tax formula in assessing its corporate income tax on NPR should not include reimbursement of payments to subcontractors in the sales factor and should not include property of subcontractors and the United States in the property factor. Alternatively, the proper basis for the corporate income taxation of NPR by Alaska is separate accounting and not unitization, as no other related corporation contributed any elements of profitability to NPR as required by the Alaska Supreme Court in *Earth Resources Co. v. State Dept. of Rev.*, 665 P. 2d 960 (Alaska 1983).

WHEREFORE, the plaintiff, the United States of America, prays as follows:

1. That this Court enter a judgment declaring (a) that imposition of Alaska corporate income tax on NPR on a worldwide basis violates the Foreign Commerce Clause and Due Process Clause of the United States Constitution; (b) that Alaska in applying the unitary tax formula in assessing its corporate income tax on NPR should not include reimbursement of payments to subcontractors in the sales factor and should not include property of subcontractors and the United States in the property factor; and, alternatively (c) that the proper basis for the corporate income taxation of NPR by Alaska is separate accounting and not unitization.

2. That this Court enter preliminary and permanent injunctions in favor of the plaintiff, the United States of America, enjoining the defendants, their employees, agents, attorneys and all those acting in concert with them who shall receive notice of the injunctions sought herein from assessing or collecting Alaska corporate income taxes from NPR on a worldwide unitary basis and from including in the unitary tax formula payments to subcontractors in the sales factor and property of the subcontractors and the United States in the property factor. Alternatively, the Court should enjoin the State of Alaska from assessing or collecting corporate income tax on any basis other than separate accounting.

3. That this Court grant the plaintiff its costs in this action and such other and further relief as is just, equitable and proper.

Dated: July 6, 1987.

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IN THE UNITED STATES DISTRICT COURT FOR THE DISTRICT OF ALASKA

UNITED STATES OF AMERICA,
Plaintiff

v.

STATE OF ALASKA; HUGH MALONE,
Commissioner of Revenue of the State of Alaska,
Defendants

CIVIL ACTION NO. A87-328 CIV

PLAINTIFF'S MEMORANDUM OF POINTS AND AUTHORITIES IN SUPPORT OF ITS MOTION FOR PARTIAL SUMMARY JUDGMENT

The plaintiff, the United States of America, has moved for partial summary judgment on the issues raised by the affirmative defenses asserted by the defendants, the State of Alaska and Hugh Malone, in their answer to the plaintiff's complaint. The central problem with those defenses is that the defendants apparently fail to recognize that because it is responsible for payment of the underlying taxes, the United States can challenge the imposition of the Alaska taxes on its contractor in federal court and because it is the sovereign, the State of Alaska's procedural requirements have no application to the Federal Government.

STATEMENT OF THE CASE

The United States filed the complaint in this action on July 7, 1987, alleging that imposition of Alaska's corporate income tax on a United States Navy and Geological Survey contractor, Husky Oil NPR Operations, Inc. ("NPR"), conflicts with the position taken by the Federal Executive in the conduct of foreign affairs and thus violates the Foreign Commerce Clause and violates the Due Process Clause of the United States Constitution, that in applying the unitary tax formula to NPR, Alaska should not include reimbursements of payments to subcontractors in the sales factor and should not include property of the United States and subcontractors in the property factor, and that, alternatively, the proper basis for the taxation of NPR's corporate income by the State is separate accounting and not unitization since no other related corporation contributed any elements of profitability to NPR as required by Alaska law. In its complaint, the United States sought a declaratory judgment and preliminary and permanent injunctions enjoining the defendants from assessing or collecting Alaska corporate income taxes from NPR on a worldwide unitary basis and from including in the unitary tax formula, payments to subcontractors in the sales factor and the property of the United States and subcontractors in the property factor, and in the alternative from assessing or collecting corporate income taxes from NPR on any basis other than separate accounting.

* * *

[p.8] ARGUMENT

I

THE COMPLAINT OF THE UNITED STATES STATES [sic] A CLAIM UPON WHICH RELIEF MAY BE GRANTED

The challenge of the United States to the assessment issued by the Alaska Department of Revenue as modified by the administrative decision states a claim upon which relief may be granted because: (1) the taxation of NPR on a worldwide unitary basis violates the Commerce Clause and the Due Process Clause of the

United States Constitution; (2) reimbursement by the U.S. for payments made to subcontractors by NPR should not be included in the sales factor of the unitary formula; (3) no property of the subcontractors or of the Government should be included in the property factor of the formula because NPR did not own or rent the property and did not have exclusive use or control of the property; and alternatively (4) the proper method of taxation of NPR is separate accounting.

A. *Taxation on a Worldwide Unitary Basis*

Taxation on a worldwide unitary basis is unconstitutional because it conflicts with the position taken by the Federal Executive in the conduct of foreign affairs and thus violates the Foreign Commerce Clause of the United States Constitution. This argument is based upon the tests set forth by the United States Supreme Court in *Japan Line, Ltd. v. County of Los Angeles*, 441 U.S. 207 (1980), and *Container Corp. of America v. Franchise Tax Board*, 463 U.S. 159 (1983).

The United States has taken the position in the conduct of foreign affairs that the worldwide unitary tax is at odds with the "arm's length" accounting method and adherence to the "arms length" method of taxing corporations engaged in foreign commerce is essential to avoid impairing foreign policy and to avoid impairing the international standard. The United States has taken this position through the Secretary of State who wrote letters to the Governors of the six states which at the time taxed on a worldwide unitary basis, and, as recognized by the Court in *Barclays Bank of Ca. v. Franchise Tax Board*, No. 325061 (Sup. Ct. of Ca., County of Sacramento) (a copy of which is attached hereto as Ex. 1), through the filing of amicus curiae briefs by the Department of Justice. The Court in the *Barclays* case, relying upon the arguments made by the United States, recently held that California's taxation of a domestic subsidiary of a foreign parent on a worldwide unitary basis was unconstitutional because it violated the Foreign Commerce Clause and Due Process Clause of the Federal Constitution.

The Alaska tax scheme is no different from the California tax system challenged in the *Barclays* case. The Alaska tax cannot be

constitutionally applied to the foreign parent, Husky Oil, Ltd., of the domestic subsidiary, NPR, because the tax impermissibly interferes with the conduct of foreign affairs by the Federal Executive, taxation on a worldwide unitary basis has caused conflicts between the United States and foreign nations and led to the adoption of retaliatory legislation, and the tax contravenes established federal policy. The Alaska tax like its California counterpart violates the *Japan Line* and *Container Corp.* standards by interfering with the conduct of foreign affairs in areas in which the Federal Government must speak with one voice and therefore, conflicts with the Foreign Commerce Clause and is unconstitutional.

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DISTRICT OF
ALASKA
By /s/ ________ Deputy

IN THE UNITED STATES DISTRICT COURT FOR THE DISTRICT OF ALASKA

UNITED STATES OF AMERICA,
Plaintiff

v.

STATE OF ALASKA; HUGH MALONE,
Commissioner of Revenue of the State of Alaska,
Defendants

CIVIL ACTION NO. A87-328 Civ.

AMENDED COMPLAINT FOR DECLARATORY RELIEF AND RETURN OF MONEY HAD AND RECEIVED

The plaintiff, the United States of America, by and through its undersigned attorneys, complains and alleges as follows:

1. This is a civil action instituted by the United States for the purpose of obtaining a declaratory judgment that (a) imposition of Alaska's corporate income tax on a federal contractor on a worldwide unitary basis is unconstitutional, (b) that the State of Alaska in violation of due process failed to adjust the assessment of the federal contractor when ordered to do so by its own hearing examiner; (c) that Alaska in applying the unitary tax formula in making an assessment of corporate income tax against the involved federal contractor should not include reimbursement of

payments to subcontractors in the sales factor; (d) and should not include property of subcontractors and the United States in the property factor of said formula and alternatively (d) that the proper basis for corporate income taxation by the State of Alaska of the federal contractor should be separate accounting, not unitization, and for the purpose of obtaining a return of the corporate income tax, penalties and interest paid to the State by the United States in satisfaction of the assessment of the federal contractor.

2. This action is brought by the United States at the request of the Department of the Interior, at the direction of the Attorney General of the United States and has been brought to vindicate the sovereign rights and pecuniary interests of the United States.

3. Jurisdiction over this action is conferred upon this Court by virtue of the provisions of Sections 1331 and 1345 of Title 28, United States Code, because this is an action arising under the United States Constitution, and is brought by the United States of America.

* * *

[P.9] 20. In accordance with the provisions of 48 C.F.R. Part 31.205-41, which is incorporated by reference into the contract between NPR and the Geological Survey, on October 31, 1988, the United States paid $1,318,191.00, the entire amount of corporate income taxes assessed against NPR for the tax years 1976, 1977 and 1978 based upon the final assessment issued by the Department of Revenue on February 10, 1988, and the interest on that assessment to October 31, 1988, $1,414,285.00, for a total of $2,732,476.00. On December 21, 1988, the United States paid $329,547.75, the entire amount of corporate income tax penalties assessed against NPR by the State of Alaska for the years 1976, 1977 and 1978. Thus, the United States has paid the State of Alaska $3,062,023.75 for corporate income taxes, interest and penalties, assessed against Husky Oil NPR.

21. Imposition of the Alaska corporate income tax on NPR on a worldwide basis violates the Foreign Commerce and Due Process Clauses of the United States Constitutional. The failure of the Department of Revenue to adjust the assessment by

removing Gate City Steel and Husky Industries from the unitary group violates the Due Process Clause of the Federal Constitution and the issuance of the final assessment on the basis that requested information was not submitted when no deadline for the submission of the information was prescribed is also a violation of the Due Process Clause. Alaska in applying the unitary tax formula in assessing its corporate income tax on NPR should not include reimbursement of payments to subcontractors in the sales factor and should not include property of subcontractors and the United States in the property factor. Alternatively, the proper basis for the corporate income taxation of NPR by Alaska is separate accounting and not unitization, as no other related corporation contributed to or received from NPR any elements of profitability as required by the Alaska Supreme Court in *Earth Resources Co. v. State Dept. of Rev.*, 665 P. 2d 960 (Alaska 1983).

WHEREFORE, the plaintiff, the United States of America, prays as follows:

1. That this Court enter a judgment declaring (a) that imposition of Alaska corporate income tax on NPR on a world-wide basis violates the Foreign Commerce Clause and Due Process Clause of the United States Constitution; (b) the failure of the Department of Revenue to adjust the assessment by removing Gate City Steel and Husky Industries from the unitary group violates the Due Process Clause of the United States Constitution; (c) that Alaska in applying the unitary tax formula in assessing its corporate income tax on NPR should not include reimbursement of payments to subcontractors in the sales factor and should not include property of subcontractors and the United States in the property factor; and, alternatively (d) that the proper basis for the corporate income taxation of NPR by Alaska is separate accounting and not unitization.

2. That this Court order the defendants to return, with interest, the $3,062,023.75 paid by the United States to the State of Alaska for corporate income taxes, penalties and interest assessed against NPR for the tax years 1976, 1977 and 1978.

3. That this Court grant the plaintiff its costs in this action and such other and further relief as is just, equitable and proper.

Dated: September 14, 1989.

MARK DAVIS
Acting United States Attorney

By: /S/ NEIL J. EVANS
NEIL J. EVANS
Assistant United States Attorney

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Attorneys for Defendants

FILED
MAR 05 1990
UNITED STATES
DISTRICT COURT
DISTRICT OF
ALASKA
By /s/ Deputy

IN THE UNITED STATES DISTRICT COURT FOR THE DISTRICT OF ALASKA

UNITED STATES OF AMERICA,
Plaintiff

v.

STATE OF ALASKA, HUGH MALONE,
Commissioner of Revenue of the State of Alaska,
Defendants

CIVIL ACTION NO. A87-328 Civ.

JOINT STATUS REPORT

The parties, through their undersigned attorneys, pursuant to the November 7, 1989 order of this Court, hereby submit the following joint status report:

1. The parties have agreed to a settlement in principle of this litigation. The settlement has been approved by the respective governmental entities.

2. The parties have not agreed to a specific dollar amount of tax payments and refund. The United States has presented tax figures for the three tax years in question and is now attempting to answer questions raised by the Alaska Department of Revenue about those figures. This is a time-consuming process because the attorneys for the United States are located in Washington, D.C., the federal contractor, Husky NPR, no longer is an active corporation, the two former employees who have knowledge relevant to the taxes are retired and living in Cody, Wyoming, and Husky NPR's records are located in Calgary, Alberta, Canada, and in a warehouse in Anchorage, Alaska. Once the tax figures are agreed upon, interest on the payments and on the amount to be refunded must be calculated.

3. The parties believe that the details of the settlement, including the specific tax and refund amounts, can be worked out within ninety days.

Dated: March 1, 1990

MARK R. DAVIS
Acting United States Attorney
NEIL J. EVANS
Assistant U.S. Attorney

JOHN J. McCARTHY
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Attorneys, Tax Division
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By: /s/ NEIL J. EVANS
NEIL J. EVANS

Attorneys for Plaintiff

DOUGLAS B. BAILY
Attorney General
JAMES FORBES
Assistant Attorney General

By: /s/ JAMES FORBES
JAMES FORBES

Attorneys for Defendants

In the Supreme Court
OF THE
United States

OCTOBER TERM, 1993

(44)
No. 92-1384

BARCLAYS BANK PLC,
Petitioner,
VS.
FRANCHISE TAX BOARD,
AN AGENCY OF THE STATE OF CALIFORNIA,
Respondent.

(29)
No. 92-1839

COLGATE-PALMOLIVE COMPANY,
Petitioner,
VS.
FRANCHISE TAX BOARD,
AN AGENCY OF THE STATE OF CALIFORNIA,
Respondent.

On Writ of Certiorari to the Court of Appeal of the State of California in and for the Third Appellate District

PETITIONERS' OPPOSITION TO CALIFORNIA LEGISLATURE'S MOTION FOR LEAVE TO FILE BRIEF AMICUS CURIAE

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OF THE

United States

October Term, 1993

No. 92-1384

Barclays Bank PLC,
Petitioner,

vs.

Franchise Tax Board,
An Agency of The State Of California,
Respondent.

No. 92-1839

Colgate-Palmolive Company,
Petitioner,

vs.

Franchise Tax Board,
An Agency of The State Of California,
Respondent.

On Writ of Certiorari to the Court of Appeal of the State of California in and for the Third Appellate District

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PETITIONERS' OPPOSITION TO CALIFORNIA LEGISLATURE'S MOTION FOR LEAVE TO FILE BRIEF AMICUS CURIAE

Petitioners Barclays Bank PLC ("Barclays") and Colgate-Palmolive Company ("Colgate") hereby oppose the California Legislature's Motion for Leave to File Brief Amicus Curiae.[1] The California Legislature's motion should be denied because (1) the brief is an improper second brief of a party, the State of California, whose interests are already adequately represented by Respondent, and (2) there is no evidence before this Court that the California Legislature authorized the filing of an amicus brief.

It is self-evident that a party to a dispute may not file an amicus brief on its own behalf. Thus, in *United States v. Smith*, the U.S. District Court denied the U.S. Sentencing Commission, an agency of the federal government, permission to appear as amicus because the U.S. Government was already a party to the dispute. *United States v. Smith*, 686 F. Supp. 847, 853 n.9 (D. Colo. 1988). The court stated that "[a] clear precondition of appearing as an amicus curiae . . . is that the movant not be a party to the dispute at issue."

Here Respondent and the California Legislature are both arms of the State of California. The State of California's designated representatives are already before this Court. The California Legislature vested Respondent with the power and duty of enforcing California's tax upon corporations in civil actions and designated the California Attorney General as Respondent's counsel. Cal. Rev. & Tax. Code §§ 19371-19372, 19382-19389 (West Supp. 1994). When the Attorney General appears, the State of California is in court. *California and Northern Ry. v. State*, 1 Cal. App. 142, 144 (1905).

Moreover, the interests of the California Legislature and Respondent in this case are the same. The California Legis-

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[1] There have been no changes to the Rule 29.1 Statements in the above referenced consolidated case since the Briefs of the Petitioners were filed with this Court.

lature alleges that its interest is to represent California's "power to enact legislation to impose tax." However, the California Attorney General, as the State's chief law enforcement officer, represents all the rights and interests of the State of California in all civil tax matters, including these cases. Cal. Gov't Code § 12511 (West 1992); *People v. Birch Securities*, 86 Cal. App. 2d 703 (1948), *cert. denied*, 336 U.S. 936 (1949). Respondent's power to collect and defend a disputed tax embodies California's power to tax; these powers cannot be wrenched apart. The California Legislature's brief amicus curiae is an improper second appearance by the State of California that subverts this Court's briefing rules. S. Ct. Rules 24, 25, 33 and 37.

Even if the California Legislature were a separate party, its brief would be inappropriate. When the interests of an amicus are adequately represented, its brief is unnecessary and unduly burdens the Court. S. Ct. Rule 37.1; *see, e.g., In re Oskar Tiedemann and Co.*, 289 F.2d 237, 240 n.5 (3d Cir. 1961); *United States v. Andrews*, 1983 WL 18974 (N.D. Ill. 1993) (mem.). The California Attorney General has been defending the State's sovereign taxing powers since these cases began and the California Legislature has never asserted that the Attorney General's representation was inadequate.

There are limited circumstances when a second branch of government has been allowed to file as an amicus: when a case may impact a legislative body's law making procedures, *see, e.g., Yip v. Pagano*, 606 F. Supp. 1566 (D.N.J. 1985), *aff'd*, 782 F.2d 1033 (3d Cir. 1986); or when its position in the case was clearly at odds with the other governmental entity, *see, e.g., New York v. Uplinger*, 467 U.S. 246, 247 n.1 (1984); *United States v. Louisiana*, 751 F. Supp. 608 (E.D.L.A. 1990); *Atkins v. United States*, 556 F.2d 1028 (Ct. Cl.), *cert. denied*, 434 U.S. 1007 (1977). Neither exception is applicable here. The California Legislature has

identified no special legislative procedure that is in jeopardy. Its brief does not advocate any positions contrary to Respondent's; it merely echos Respondent's arguments.

In addition, there is no evidence that the brief filed with the Court is an authorized position of the California Legislature. Under California law, the Legislative Counsel is forbidden to appear in court proceedings without the prior approval either by resolution of the Joint Rules Committee or by concurrent resolution of both houses of the Legislature.[2] Cal. Gov't Code § 10246 (West 1992). The brief to be filed by the California Legislative Counsel contains neither an assertion of such authorization nor any other evidence that the California Legislative Counsel has the authority to speak for the California Legislature. Petitioners have diligently searched the minutes of the Joint Rules Committee and the Official Journal of the Legislature and have twice requested a copy of any such authorization from Legislative Counsel. *See* Appendices A and B. No authorization has been located. Accordingly, there is no basis for this Court to conclude that the brief filed with movant's motion is an authorized representation of the views of the California Legislature.

[2] An exception arising upon termination of the Joint Rules Committee is not applicable here.

For the foregoing reasons, we respectfully request that the Motion for Leave to File Brief Amicus Curiae filed by the California Legislative Counsel on behalf of the California Legislature be denied.

Respectfully submitted,

JOANNE M. GARVEY
Counsel of Record for
Barclays Bank PLC
HELLER, EHRMAN, WHITE & MCAULIFFE
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Counsel of Record for
Colgate-Palmolive Company
MORRISON & FOERSTER
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San Francisco, CA 94104
(415) 677-7000

APPENDIX A

[LETTERHEAD]

January 14, 1994

VIA FACSIMILE
Bill S. Heir
Deputy Legislative Counsel
State Capitol, Suite 3021
Sacramento, CA 95814-4996

Barclays Bank PLC v. Franchise Tax Board

Dear Bill:

In your conversation with Jim Kleier and me, you mentioned that you had received authorization from the Joint Rules Committee. Could you please send us a copy of the resolution or other action, either by the Joint Rules Committee or by the Legislature? It is my understanding that under the Government Code action by the Joint Rules Committee as a committee is required and that such action would be taken in an open meeting. The other alternative is, of course, a concurrent resolution by both houses of the Legislature. We have been unable to find evidence of either. Accordingly we would appreciate copies.

Very truly yours,

Joanne M. Garvey

cc: James Kleier

APPENDIX B

[LETTERHEAD]

February 11, 1994

VIA FACSIMILE
Bill S. Heir
Deputy Legislative Counsel
State Capitol, Suite 3021
Sacramento, California 95814-4996

Barclays Bank PLC v. Franchise Tax Board;
Colgate-Palmolive v. Franchise Tax Board

Dear Mr. Heir:

On January 14, 1994 I wrote you to request evidence of authorization for the Legislative Counsel's office to file an amicus curiae brief on behalf of the California Legislature in the *Barclays* and *Colgate-Palmolive* cases. Under the Government Code, such authorization would require either vote at an open and public meeting of the Joint Rules Committee or a concurrent resolution by both houses of the Legislature during open session. We have continued to search but have been unable to find evidence of either. I renew my request, also made on behalf of James Kleier, Counsel for Colgate, for a copy of the resolution or other action which permits the appearance of the Legislative Counsel in either of these cases.

Very truly yours,

Joanne M. Garvey

cc: James Kleier

IN THE
SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1993

No. 92-1384 (48)

BARCLAYS BANK PLC,
Petitioner,

v.

FRANCHISE TAX BOARD,
An Agency Of The State Of California,
Respondent.

No. 92-1839

COLGATE-PALMOLIVE COMPANY,
Petitioner,

v.

FRANCHISE TAX BOARD,
An Agency Of The State Of California,
Respondent.

**On Writ of Certiorari To The
Court Of Appeal Of The State Of California
In And For The Third Appellate District**

**SUPPLEMENTAL BRIEF OF
PETITIONERS' IN OPPOSITION TO CALIFORNIA LEGISLATURE'S
MOTION FOR LEAVE TO FILE BRIEF AMICUS CURIAE**

5 pp

On February 16, 1993 Petitioner Barclays Bank PLC ("Barclays") received a copy of a letter from the Chairman of the Joint Committee on Rules dated December 20, 1993 purportedly authorizing the Legislative Counsel to file a brief in these cases on behalf of the California Legislature.[1/] Appendix A. However, the Chairman of the Joint Rules Committee may not act on behalf of the committee without the authorization by two thirds of the committee membership at an open and public meeting. Cal. Gov't Code §§ 9027, 9028, 9917 (West 1992). No evidence of such authorization was produced. The type of authorization specifically required under Section 10246 of the California Government Code is not before this Court. Thus, there is still no basis for this Court to conclude that the brief filed with movant's motion is an authorized representation of the views of the California Legislature.

Barclays and Colgate-Palmolive Company ("Colgate") hereby renew their opposition to the California Legislature's Motion for Leave to File Brief Amicus Curiae.

Respectfully submitted,

Joanne M. Garvey
Counsel of Record for
Barclays Bank PLC
HELLER, EHRMAN, WHITE & MCAULIFFE
333 Bush Street
San Francisco, CA 94104-2878
(415) 772-6000

1/ There are no changes to the Rule 29.1 Statements in the above referenced consolidated case since the Briefs of the Petitioners were filed with this Court.

James P. Kleier
Counsel of Record for
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MORRISON & FOERSTER
345 California Street
San Francisco, CA 94104
(415) 677-7000

APPENDIX A

A-1

Legislative Counsel of California

BION M. GREGORY

State Capitol, Suite 3021
Sacramento, CA 95814-4996
(916) 445-3057
Telecopier (916) 322-0769

Sacramento, California
February 15, 1994

Heller, Ehrman, White & McAuliffe
Attorneys
333 Bush Street
San Francisco, CA 94104-2878

Attention: Joanne M. Garvey

<u>Barclays Bank PLC v. Franchise Tax Board</u>;
<u>Colgate-Palmolive v. Franchise Tax Board</u>

Dear Ms. Garvey:

Pursuant to the request in your letter dated February 11, 1994, to Mr. Heir, we have enclosed a copy of the letter memorializing the authorization of the Joint Committee on Rules for this office to represent the Legislature, as amicus curiae, in the above-referenced cases.

Very truly yours,

Bion M. Gregory
Legislative Counsel

Jack I. Horton
Chief Deputy

JIH:bjs
Enclosure

A-2

California Legislature

Joint Committee on Rules

JOHN BURTON
CHAIRMAN
WILLIAM A. CRAVEN
VICE CHAIR

Sacramento, California
December 20, 1993

Mr. Bion M. Gregory
Legislative Counsel
State Capitol, Suite 3021
Sacramento, California 95814-4996

Dear Mr. Gregory:

Pursuant to Section 10246 of the Government Code, your office is hereby authorized to represent the Legislature, as <u>amicus curiae</u>, in the cases of <u>Barclays Bank PLC</u> v. <u>Franchise Tax Board of California</u> (No. 92-1384) and <u>Colgate-Palmolive Co.</u> v. <u>Franchise Tax Board of California</u> (No. 92-1839) before the United States Supreme Court. The purpose of this representation will be to advise the Court of the development of California's unitary tax law in response to communications from the federal government and the United Kingdom.

Sincerely,

JOHN L. BURTON
Chairman, Joint Committee on Rules

cc:

Honorable Willie L. Brown, Jr.,
Speaker of the Assembly
Honorable David Roberti,
President pro Tempore of the Senate
Honorable James L. Brulte
Honorable Ken Maddy

COMMITTEE OFFICE
ROOM 3016 · STATE CAPITOL
TELEPHONE 445-2995

Nos. [illegible] and [illegible]

In the Supreme Court of the United States

OCTOBER TERM, 1993

BARCLAYS BANK, PLC, PETITIONER

v.

FRANCHISE TAX BOARD OF CALIFORNIA

COLGATE-PALMOLIVE COMPANY, PETITIONER

v.

FRANCHISE TAX BOARD OF CALIFORNIA

ON WRITS OF CERTIORARI TO THE COURT OF APPEAL OF THE STATE OF CALIFORNIA, IN AND FOR THE THIRD APPELLATE DISTRICT

BRIEF FOR THE UNITED STATES AS AMICUS CURIAE SUPPORTING RESPONDENT

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QUESTIONS PRESENTED

The United States will address the following questions:

1. Whether California's application of worldwide combined reporting (WWCR) to a foreign-controlled multinational corporation during tax year 1977 impaired the federal government's conduct of international commercial policy and therefore violated the Foreign Commerce Clause of the Constitution.

2. Whether California's application of WWCR to a domestic multinational corporation during tax years 1970-1973 violated the Foreign Commerce Clause.

3. Whether the Fourteenth Amendment to the Constitution requires California to provide a refund remedy in the event that the taxes at issue are determined to have been unlawfully imposed.

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BARCLAYS BANK, PLC, PETITIONER

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No. 92-1839

COLGATE-PALMOLIVE COMPANY, PETITIONER

v.

FRANCHISE TAX BOARD OF CALIFORNIA

ON WRITS OF CERTIORARI TO THE COURT OF APPEAL OF THE STATE OF CALIFORNIA, IN AND FOR THE THIRD APPELLATE DISTRICT

BRIEF FOR THE UNITED STATES AS AMICUS CURIAE SUPPORTING RESPONDENT

INTEREST OF THE UNITED STATES

The Constitution confers upon Congress the power to "regulate Commerce with foreign Nations" (Art. I, § 8, Cl. 3) and authorizes the President, "by and with the Advice and Consent of the Senate, to make Treaties" (Art. II, § 2, Cl. 2). The United States has a substantial interest in cases that address the constitutional allocation of authority over matters affecting foreign commerce and foreign relations. These consolidated cases present such issues. At the Court's invitation, the United States filed

a brief amicus curiae in No. 92-1384 at the petition stage.

STATEMENT

Different methods have been used to identify and allocate among taxing jurisdictions the income received by multinational corporations. The method employed by the United States is known as the "separate accounting" or "arm's length" method. This method generally treats each corporation as a distinct tax unit, required to report income from its transactions with every other corporation (including its parent, subsidiaries or affiliates) on an arm's length basis. The separate accounting method of taxation is employed in the Internal Revenue Code and in the many bilateral tax treaties to which the United States is a party (92-1384 Pet. App. H43).[1] The separate accounting method is also employed by most other nations for both domestic and international purposes.

During the tax years at issue in these cases,[2] California employed a different method of allocating corporate income known as "worldwide combined reporting" (WWCR). Under the California tax provisions then in effect, the State generally treated parents, subsidiaries and affiliates engaged in a unitary business as a single entity for tax purposes, pooled their global income, and allocated a portion of that combined income to California based upon a multi-factor formula.[3] See *Container Corp.* v. *Franchise Tax Board*, 463 U.S. 159, 162-163 (1983).

[1] There are, of course, provisions of the Internal Revenue Code designed to forestall potential abuses of the separate accounting method. See, *e.g.*, 26 U.S.C. 482.

[2] No. 92-1384 involves tax year 1977. No. 92-1839 involves tax years 1970-1973.

[3] Under legislation enacted in 1986 (effective in 1988), California provided all corporations with a "water's edge" alternative to WWCR. See Cal. Rev. & Tax. Code § 25110 (West 1992); 92-1384 Pet. App. B4 n.2. In general, the "water's edge" method permits a taxpayer to report its income separately from the income of its foreign parents or affiliates. This case does not directly consider or address the "water's edge" method of taxation because it concerns tax years that preceded California's adoption of that method.

On September 10, 1993, California enacted legislation to remove the fee the State previously had imposed on corporations that elected "water's edge" treatment under the 1986 legislation and also to remove the regulatory authority under which respondent could disregard a "water's edge" election and require a corporation to report its income on a worldwide basis. See Cal. S.B. 671, §§ 16, 23, 24, 26 (1993). Under this new legislation, all corporations subject to tax in California may now freely elect taxation under the "water's edge" method.

Petitioners in these cases contend, *inter alia*, that the former California taxing scheme violated the Foreign Commerce Clause because it "impair[ed] federal uniformity in an area where federal uniformity [was] essential, and prevent[ed] the Federal Government from speaking with one voice in international trade." *Container Corp.*, 463 U.S. at 193 (citations and internal quotations omitted). Proper resolution of this claim, we believe, requires a thorough understanding of the development of the federal government's policy regarding the States' use of WWCR.

1. Significant controversy over the States' use of WWCR first arose during the late 1970's when the Senate debated the United States-United Kingdom Tax Convention. The treaty was initially signed on December 31, 1975. Convention for Avoidance of Double Taxation, December 31, 1975, United States-United Kingdom, 31 U.S.T. 5670, T.I.A.S. No. 9682. The chief concession made by the British government was to reduce significantly the discriminatory impact of U.K. tax provisions regarding dividends paid by U.K. corporations. This provision was given an effective date of January 1, 1975, and it was expected to result in very substantial tax refunds to U.S. investors.

Within the United States, controversy over the treaty centered chiefly on Article 9(4). 31 U.S.T. 5677. As originally drafted, this provision appeared to bar the States' application of WWCR even to U.S. corporate parents with U.K. subsidiaries or affiliates. Apparently

so broad a limitation had not been intended, and in response to the States' objections the U.S. and U.K. exchanged notes making clear that the States were barred from applying WWCR only in determining the tax liability of U.K.-controlled corporations. See *Tax Treaties with the United Kingdom, the Republic of Korea and the Republic of the Philippines: Hearings Before the Senate Comm. on Foreign Relations*, 95th Cong., 1st Sess. 305-306 (*1977 Hearings*) (1977) (Treasury Department Memorandum). So modified, the treaty was transmitted to the Senate by President Ford on June 24, 1976. 122 Cong. Rec. 20,348 (1976).

Even after this revision, individuals both inside and outside the Senate continued to express a wide range of objections to Article 9(4). Restrictions on the States' use of WWCR were said to constitute an improper interference with state autonomy. See, *e.g.*, 124 Cong. Rec. 18,427 (1978) (Sen. Stevens). Other Senators took the less sweeping position that any federal limitations on the States' taxing powers should be effected by legislation rather than through an international agreement negotiated by the executive branch alone. See, *e.g.*, *id.* at 18,417 (Sen. Church); *id.* at 18,423 (Sen. Kennedy). Some participants, chiefly state taxing officials, argued that the arm's length method was unworkable and subject to manipulation by corporate taxpayers. See, *e.g.*, *ibid.*; *1977 Hearings* 69 (prepared statement of the National Association of Tax Administrators). Opponents of the provision warned that the treaty would establish a dangerous precedent, and that the States' freedom to apply WWCR to the corporations of other countries would quickly be negotiated away. Senator Church led the opposition in the Senate, offering a reservation that would render Article 9(4) inapplicable to political subdivisions. See 124 Cong. Rec. 18,416 (1978).

Those who opposed the Church reservation (and supported the treaty with Article 9(4) included) countered with a variety of arguments. Advocates of Article 9(4) relied in substantial part upon the contention that the

arm's length approach provided a superior method for distinguishing foreign from domestic income. In a letter to the head of the California Franchise Tax Board dated February 15, 1977,[4] Secretary of the Treasury Blumenthal stated that "[t]he unitary apportionment system is inconsistent with accepted tax treaty policy which prohibits one country from taxing the business profits of an enterprise of the other unless that enterprise is engaged in business through a permanent establishment in the first country." The letter explained that "[u]nder unitary apportionment, if the profit rate of a foreign member of a unitary group exceeds the profit rate of the member doing business in California, the effect is tantamount to taxing the profits of the foreign enterprise." Blumenthal went on to state that "it is our experience, as well as that of most other countries, that the determination of income on the basis of an arm's-length standard is not only more accurate but also far less arbitrary," and argued that California's use of an apportionment method different from "the internationally accepted approach" would often lead to double taxation. The Secretary also stated that "[t]he unitary system imposes a substantial compliance burden on multinational corporations" and that the government was "aware of cases where this burden has discouraged foreign investment in the United States." The letter concluded: "For all of these reasons, I repeat, the provisions of the proposed income tax treaty with the United Kingdom seem to me wholly appropriate and desirable."

Treasury officials also emphasized, however, that the provision's impact on the States should be small because the treaty applied only to U.K.-controlled corporate taxpayers, leaving the States free to employ WWCR in taxing the income of corporations controlled by the nationals of other foreign countries. Thus, Assistant Secretary of the Treasury Laurence N. Woodworth explained that un-

[4] Secretary Blumenthal's letter is reprinted in *1977 Hearings* 104-105.

der Article 9(4), "if the U.K. corporation is itself controlled by, say, a New York corporation, or by a Dutch corporation, California may take into account the income and expense of the entire group." *1977 Hearings* 35. Opponents of the Church reservation also emphasized the closely related argument that Article 9(4) should be viewed not in isolation, but as a necessary quid pro quo for substantial concessions made by the British. Secretary Blumenthal reminded the head of the California Franchise Tax Board that "a treaty is a negotiated document containing a number of concessions by both partners. In the pending treaty, the United Kingdom made very important concessions, particularly in the treatment of dividends paid to U.S. investors. We view the Article 9(4) provision as an appropriate quid-pro-quo for the concessions made by the United Kingdom." *1977 Hearings* 104. In a subsequent letter to state Governors dated April 28, 1978, the Secretary sounded a similar theme, stating: "I realize that the merits of the unitary method can be debated. My purpose in writing is not to enter that debate but simply to note that the treaty restriction on this method represents a narrowly drawn and relatively minor concession, by any measure, in relation to the overall balance of benefits in the treaty." Letter from the Secretary of the Treasury to State Governor 2 (Apr. 28, 1978). A Treasury Department memorandum, responding to objections to Article 9(4) raised in testimony before the Senate Foreign Relations Committee, contested the assertion that "every treaty country will obtain the same provisions as the United Kingdom." The memorandum responded that "renegotiation of our complete treaty network will not occur for several years; and the Treasury Department will agree to the provision only in the context of a treaty beneficial to the United States." *1977 Hearings* 305.[5]

[5] On the final day of floor debate, Senator Javits relied heavily on this rēpresentation, stating that "[i]f the treaty is approved, Treasury will consider the inclusion of similar provisions in other treaties, but only in return for commensurate concessions on the other side." 124 Cong. Rec. 18,657 (1978). Senator Javits had previously characterized Article 9(4) as "but a part of a larger whole which is of great interest and of great importance to the United States," and as "a concession which we have made to the United Kingdom." 124 Cong. 18,418 (1978). Other Senators expressed similar views, opposing the Church reservation on the ground that the treaty *as a whole* would benefit the United States, and that acceptance of the Church reservation would imperil British acceptance of the accord. See *id.* at 18,652-18,653 (Sen. Hayakawa); *id.* at 18,669 (Sen. Dole).

On June 23, 1978, the Senate voted 44-34 to reject the Church reservation. 124 Cong. Rec. 18,670. The subsequent vote on the treaty itself was 49-32 in favor, *ibid.*—five votes less than the two-thirds required by the Constitution. On June 27, 1978, the treaty was approved by the Senate subject to the Church reservation. *Id.* at 19,076. U.S. and U.K. negotiators ultimately agreed upon a third protocol to the treaty, which incorporated the Church reservation on a bilateral basis and included concessions to the British on offshore drilling profits and the insurance premiums excise tax. That protocol was approved by the Senate by a vote of 98-0 (125 Cong. Rec. 17,433 (1979)) and soon thereafter was approved by the House of Commons.

The Carter Administration addressed the WWCR issue on at least one additional occasion. On March 31, 1980, Assistant Secretary of the Treasury for Tax Policy Donald C. Lubick presented before the House Ways and Means Committee the Treasury Department's views on H.R. 5076 (96th Cong., 2d Sess. (1980)), a bill that would have essentially barred the States' use of WWCR. The Assistant Secretary's statement noted that "[a]lthough the bill makes no distinction between corporate groups under United States control and those under foreign control, such a distinction may be warranted." 92-1384 J.A. 588. He explained, in particular, that "the application of a unitary system to U.S. controlled corporate groups represents much less of an international irritant, if in fact that problem is present at all." *Id.* at 589. The statement con-

cluded that "[t]he Treasury Department supports the goals of [this provision] of the bill, with respect to affiliated groups controlled by foreign persons. We do not oppose the provisions of [this part] of the bill insofar as U.S. controlled corporate groups are concerned." *Ibid.*

2. The brief amicus curiae filed by the United States in *Chicago Bridge & Iron Company* v. *Caterpillar Tractor Co.*, No. 81-349, in January 1982 was in two respects a departure from prior executive branch practice. For the first time the government's criticisms of the worldwide method were couched in constitutional terms. Second, the government's opposition to the States' use of WWCR was extended to cover the method's application to domestic corporations with foreign subsidiaries.[6] The government argued, *inter alia*, that the Illinois taxing scheme was invalid because the "unitary method impairs the otherwise uniform international custom that is the basis of the treaties between the United States and numerous foreign countries that are intended to prevent international double taxation of income." Br. 16. The brief noted that several foreign governments had protested the States' continued use of WWCR. *Ibid.* The brief did not, however, cite any statement by an executive branch official setting forth the position of the federal government regarding the States' use of WWCR.

Chicago Bridge & Iron was held over to the following Term, and the Court granted certiorari in *Container Corp.* The United States did not submit a brief in *Container Corp.*, and this Court upheld the use of WWCR as applied to a domestic corporation with foreign subsidiaries. The Court distinguished its prior decision in *Japan Line, Ltd.* v. *County of Los Angeles*, 441 U.S. 434

[6] The brief acknowledged, however, that application of WWCR to foreign-controlled corporations raised even greater concerns; accordingly, the brief cautioned that "the Court should not decide this case on any ground that would foreclose any claims that may be raised in a future case involving the imposition of the combined reporting method to a group of corporations with a foreign parent." 81-349 Amicus Br. at 19.

(1979), by noting, *inter alia*, that "in this case, unlike *Japan Line*, the Executive Branch has decided not to file an *amicus curiae* brief in opposition to the state tax." 463 U.S. at 195. It acknowledged the government's filing in *Chicago Bridge & Iron*, but asserted that "there has been no indication that the position taken by the Government in *Chicago Bridge & Iron Co.* still represents its views, or that we should regard the brief in that case as applying to this case." *Id.* at 195 n.33. The dissent took issue with this statement, arguing that there was "no reason to ignore [the Government's] view in one case currently pending before the Court when considering another case that raises exactly the same issue," and noting that "[t]he Solicitor General has not withdrawn his memorandum, nor has he supplemented it with anything taking a contrary position." *Id.* at 204 (Powell, J., dissenting).

This Court's decision in *Container Corp.* was issued on June 27, 1983.[7] In the wake of that decision, President Reagan established the Worldwide Unitary Taxation Working Group, a diverse group of federal and state officials and representatives of the business community. That group was "charged with producing recommendations . . . that will be conducive to harmonious international economic relations, while also respecting the fiscal rights and privileges of the individual states." Chairman's Report on the Worldwide Unitary Taxation Working Group at 3 (1984). The Group considered comments from a wide spectrum of interested parties, including foreign governments and foreign taxpayers.

On July 31, 1984, Secretary of the Treasury Regan, as chairman of the Worldwide Unitary Taxation Working Group, transmitted his report to the President. Members of the Working Group agree on three principles that should guide state taxation of multinationals' income: (1) a water's edge limitation on the States' application of

[7] Nine days later the Court dismissed the appeal in *Chicago Bridge & Iron* for want of a substantial federal question. *Chicago Bridge & Iron Co.* v. *Caterpillar Tractor Co.*, 463 U.S. 1220 (1983).

formula apportionment to both foreign and domestic corporations; (2) federal administrative assistance to the States in their application of the arm's length method; and (3) "[c]ompetitive balance for U.S. multinationals, foreign multinationals, and purely domestic businesses." Chairman's Report at ii.

The report did not propose immediate federal action to implement these principles. Rather, Secretary Regan's cover letter noted that "[i]f states enact legislation based on the three principles agreed upon by the Working Group, the United States will be able to speak with one voice in dealing with its foreign trading partners, and this irritant to international commercial relations will have been eliminated." Chairman's Report at iii. Secretary Regan recommended that the administration should support federal legislation only if the States failed to make appreciable progress in implementing the Group's recommendations within a suitable interval. *Ibid.*

3. Subsequent progress at the state level proved inadequate, however, and on November 8, 1985, President Reagan issued a statement calling for federal legislation to impose a water's edge standard on state taxation of multinationals. 92-1839 J.A. 7. The President stated that "[s]ince states have not universally accepted these principles, I am instructing the Secretary of the Treasury to initiate the process of crafting Federal legislation to incorporate these principles into law." *Ibid.* The President's statement also noted that "[f]urther, I am instructing the Attorney General to ensure that the United States' interests are represented in appropriate controversies and cases consistent with this approach." *Id.* at 8.

On December 18, 1985, the Treasury Department proposed legislation that would prohibit the States' use of WWCR and provide the States with federal assistance in their application of the arm's length method. That legislative proposal was introduced in the Senate as S. 1974 (99th Cong., 1st Sess. (1985)), and in the House as H.R. 3980 (99th Cong., 1st Sess. (1985)). In a letter addressed to the Speaker of the House and President of the

Senate, Secretary of the Treasury Baker explained that "[t]he practice of a small but important minority of the states of assessing corporate income tax on a worldwide unitary basis has caused serious difficulties with the conduct by the federal government of our foreign economic policy." Letter from the Secretary of the Treasury to the President of the Senate 1 (Dec. 18, 1985) (hereafter "Baker letter"). The Secretary noted that this country's trading partners had raised numerous objections to the worldwide method and stated, "We agree with these contentions." *Ibid.* The Secretary further observed that continued use of WWCR at the state level had resulted in the adoption (though not yet in the implementation) of retaliatory legislation by the U.K., and he asserted that "[i]t has become clear that the ability of the federal government to speak with one voice in the conduct of foreign economic affairs is significantly weakened because of these state tax practices." *Ibid.*

The Secretary acknowledged that significant progress had been made after dissemination of the Working Group's recommendations, but he concluded that "[t]he failure to date to achieve voluntary compliance by all states with the principles adopted by the Working Group, and the increasing international difficulties caused by continued adherence by a few states to the worldwide unitary method, have led the Administration to conclude that restrictive legislation should now be adopted." Baker letter at 2. The Secretary also noted that the administration bill would bar the use of WWCR as to both foreign and domestic corporations. He acknowledged that "the principal foreign commerce issues raised by state worldwide unitary taxation would be resolved if states were to agree that they would not impose worldwide unitary tax on foreign controlled entities." *Ibid.* The Secretary asserted, however, that such an approach would cause other serious problems by effecting a form of discrimination between domestic and foreign businesses (in favor of the latter). *Ibid.* The Secretary also emphasized that the legislation

provided for federal assistance in the States' administration of the arm's length method. *Id.* at 2-3.

On January 30, 1986, Secretary of State Shultz wrote to the governors of the States that continued to employ WWCR. The letter stated: "I am writing to explain to you the foreign policy concerns that prompted this legislation and to urge you to act promptly to reconsider your state's use of the worldwide unitary method of taxation." 92-1384 J.A. 601. The letter noted that the States' use of WWCR had prompted diplomatic complaints from numerous countries and retaliatory legislation from the U.K., and concluded: "For these reasons I believe state worldwide unitary taxation to be inappropriate. Continued state taxation on a worldwide unitary basis will greatly impair the ability of the federal government to carry out its tax and investment policy in the international arena and to manage the sensitive issue of international double taxation." *Id.* at 602-603.

On March 7, 1986, the United States filed a brief amicus curiae in *Alcan Aluminum Ltd.* v. *Franchise Tax Board*, No. 84-C-6932 (N.D. Ill.), a suit seeking injunctive relief against California's application of WWCR to foreign corporations. The government's brief argued that the California tax violated the Foreign Commerce Clause. The Shultz letter was attached as an exhibit in support of the contention that the California law had adversely affected the nation's foreign policy.[8]

On September 29, 1986, J. Roger Mentz, Assistant Secretary of the Treasury for Tax Policy, testified before a Senate subcommittee regarding the pending legislative proposal. Assistant Secretary Mentz asserted that significant progress had been made in inducing States to abandon WWCR without the passage of federal legislation, and that "the most significant progress is California." S. Hrg. 1066, 99th Cong., 2d Sess. 63 (Sept. 29, 1986). (California had amended its tax statute on September 5, 1986, to provide for a water's edge election, albeit an election contingent upon the payment of a significant fee. See note 3, *supra.*) The Assistant Secretary acknowledged that "California's legislation also has some elements in it that are inconsistent with the President's statement, and with S. 1974," but concluded, "since there has been such significant progress, that restrictive Federal legislation is not warranted at this time." *Ibid.* Instead, the Assistant Secretary recommended that "congressional action on S. 1974 should be deferred until the remaining worldwide unitary states have a full opportunity to act, California has an opportunity to consider and respond to comments on its recently enacted legislation, and we have an opportunity to evaluate the actual operation of water's edge legislation passed by the several states when fully in effect." *Id.* at 71-72 (92-1384 J.A. 441).

4. The federal government continued its involvement, however, in litigation challenging the constitutionality of the former California taxing scheme. On September 17, 1986, the United States filed a brief amicus curiae in the California Superior Court supporting Barclays Bank in the instant suit for refund of taxes paid in tax year 1977. In support of its claim that California's use of WWCR had undermined the federal government's conduct of foreign economic policy, the brief cited (1) the Shultz letter of January 30, 1986, (2) the retaliatory legislation enacted by the U.K. in the summer of 1985, and (3) protests received from other trading partners. The government maintained its support for Barclays throughout the state-court litigation.[9] The United States has not, how-

[8] The complaint in *Alcan* was dismissed on jurisdictional grounds. The United States did not participate in the case in either the court of appeals or this Court, in which the only issue was federal jurisdiction. This Court ultimately held that Alcan's suit was barred by the Tax Injunction Act, 28 U.S.C. 1341. See *Franchise Tax Board* v. *Alcan Aluminium Ltd.*, 493 U.S. 331, 338-341 (1990).

[9] At an earlier stage of this case, the United States expressed in this Court the view that California's application of WWCR to foreign-controlled corporate multinationals violated the Commerce Clause. 92-212 U.S. Amicus Br. at 12-13.

ever, participated as amicus curiae at any stage of Colgate's lawsuit.

SUMMARY OF ARGUMENT

1. A state taxing scheme may not constitutionally be applied to foreign commerce if it will "impair federal uniformity in an area where federal uniformity is essential, and prevent[] the Federal Government from speaking with one voice in international trade. *Container Corp.*, 463 U.S. at 193 (citation and internal quotations omitted). In applying this test to concrete cases, the question is whether the state action at issue is incompatible with federal policy as adopted and explicated by officials of the executive and legislative branches. In undertaking this inquiry, moreover, the court must look to federal policies in effect at the time the tax was levied, lest States unjustly be held liable for refunds of taxes that violated no federal policy, and were thus in no way unlawful, at the time the disputed tax liability was incurred.

2. Judged against this standard. Barclays' claim must fail. As of 1977 (the tax year in question) executive branch officials had expressed a preference for the arm's length method and had negotiated a treaty prohibiting application of WWCR to U.K.-controlled corporate taxpayers. These officials had not, however, indicated that further use by the States of WWCR would be incompatible with a standard to which the United States was committed by general agreement with its trading partners. To the contrary, executive branch officials during the treaty debate gave assurances that in the event of the treaty's approval by the Senate, States could continue to apply WWCR to corporations controlled by other (*i.e.*, non-U.K.) foreign nationals, and that their right to do so would not be bargained away except in return for concessions from our trading partners. Against this backdrop, the executive branch's negotiation of the treaty and

efforts to effect its approval by the Senate cannot accurately be viewed as manifesting a then-existing federal policy requiring uniformity among the States.

3. Colgate-Palmolive Company, a domestic corporation, seeks refunds of taxes paid from the years 1970-1973. That claim should be denied. During the years in question, no federal policy precluded the States' application of WWCR to domestic taxpayers; indeed, the U.S.-U.K. treaty was renegotiated in 1976 to make clear that it would not bar the States from applying the worldwide method to domestic corporations with British subsidiaries. Moreover, although the executive branch in 1982 and thereafter has opposed the application of WWCR to domestic taxpayers, that opposition has not been based on foreign relations concerns. California's application of WWCR to Colgate should be upheld even if Barclays prevails in its legal challenge, since Colgate's "equal treatment" argument is without merit.

4. Finally, if this Court concludes that the taxes at issue in these cases were unlawfully collected, it should make clear that in the unusual circumstances presented here, California is under no federal constitutional obligation to provide refunds. The taxes here were not inherently beyond California's power to levy; petitioners were not immune from income taxation in California, and they did not suffer unlawful discrimination vis-a-vis some other class of taxpayers. Rather, the gravamen of petitioners' claim is that California's use of WWCR during prior years impaired the federal government's ability to conduct foreign commercial policy. California's payment of money to the petitioners will not, of course, undo any disruption of federal government policy that may have already occurred, and in light of the recent modification of California's tax scheme, the executive branch has concluded that the provision of refunds for past years is unnecessary to protect the federal government's ability to speak with one voice in international trade.

ARGUMENT

1. This Court's opinion in *Complete Auto Transit, Inc.* v. *Brady*, 430 U.S. 274, 279 (1977), sets forth the factors governing dormant Commerce Clause challenges to the States' regulation of domestic commerce. This Court has made clear, however, that "an inquiry more elaborate than that mandated by *Complete Auto* is necessary when a State seeks to tax the instrumentalities of foreign, rather than of interstate, commerce." *Japan Line,* 441 U.S. at 451. In particular, a state taxing scheme may not constitutionally be applied to foreign commerce if it will "impair federal uniformity in an area where federal uniformity is essential, and prevent[] the Federal Government from speaking with one voice in international trade." *Container Corp.,* 463 U.S. at 193 (citation and internal quotations omitted).[10]

This more searching scrutiny is appropriate, in part, because "[f]oreign commerce is preeminently a matter of national concern." *Japan Line*, 441 U.S. at 448. In addition, however, this Court's approach reflects a recognition that in the sphere of foreign relations, federal officials are particularly likely to act by methods lacking legal formalities. That is, in the foreign sphere, federal policy is especially likely to take the form of informal agreements, understandings, long-term strategies, etc., that have not been codified in a statute or treaty. Cf. *United States* v. *Curtiss-Wright Export Corp.,* 299 U.S. 304, 320 (1936) (noting that President's power in the

[10] As an initial matter, the United States notes its disagreement with the California Supreme Court's reliance on this Court's decision in *Wardair Canada Inc.* v. *Florida Department of Revenue,* 477 U.S. 1 (1986). The most extensive congressional consideration of the States' use of WWCR—the 1977-1978 debate over ratification of the U.S.-U.K. Tax Convention—produced a substantial majority within the Senate in favor of Article 9(4). The Senate's final action on the treaty, in our view, should not be seen as affirmative permission for States to use the worldwide method; indeed, much of this Court's analysis in *Container Corp.* would have been unnecessary if Congress had already spoken.

field of international relations "does not require as a basis for its exercise an act of Congress").[11] The President's ability to deal with foreign governments in an effective manner would be seriously undermined if the accords he reaches could not be binding upon the States. Inquiry under the Commerce Clause is thus particularly searching where *foreign* commerce is concerned, because in this context it is particularly likely that a state law will disrupt federal *policy* even where it is preempted by no federal *law*.[12]

The difficulty, of course, lies in identifying those areas "where federal uniformity is essential." In the present dispute, it is quite clear that federal law has long embodied a *preference* for the arm's length method, in the sense that this method is used in computing the federal income tax liability of multinational corporations. This Court has recognized, however, that "[c]oncurrent federal

[11] Supersedure of state law by federal policies uncodified in any statute, treaty, or regulation is unusual, but it is not confined to the Foreign Commerce Clause. In *Boyle* v. *United Technologies Corp.*, 487 U.S. 500 (1988), for example, this Court held that a state-law tort suit alleging negligent design could not lie against a contractor that had furnished military equipment to the government in compliance with precise contractual specifications. In areas of "uniquely federal interest," the Court recognized, state law would be displaced where "a significant conflict exists between an identifiable federal policy or interest and the operation of state law." 487 U.S. at 507 (brackets and internal quotations omitted).

[12] It is entirely clear, of course, that a federal statute or treaty prohibiting the States' use of WWCR would be a permissible exercise of federal power. In a certain sense it is thus at least potentially misleading to say that a State's method of taxation can ever "prevent" the federal government from speaking with one voice. See *Itel Containers Int'l Corp.* v. *Huddleston*, 113 S. Ct. 1095, 1108 (1993) (Scalia, J., concurring in part and concurring in the judgment). The danger, more precisely stated, is that a State's taxing scheme may prevent the federal government from implementing its policies *by methods other than statutes or treaties.* That danger is particularly acute in the realm of foreign relations, where important international understandings may for various reasons be less formalized.

and state taxation of income, of course, is a well-established norm. Absent some explicit directive from Congress, we cannot infer that treatment of foreign income at the federal level mandates identical treatment by the States." *Mobil Oil Corp.* v. *Commissioner of Taxes*, 445 U.S. 425, 448 (1980). Nor is it dispositive that the federal government has not embraced the WWCR method under its numerous bilateral agreements. This Court must look in addition to other factors to determine whether divergence between state and federal methods of taxation is tolerable in a particular sphere. We believe the Court's inquiry should be guided by the following principles:

a. This Court in *Container* observed that "[t]he most obvious foreign policy implication of a state tax is the threat it might pose of offending our foreign trading partners and leading them to retaliate against the Nation as a whole." 463 U.S. at 194. Accord, *Japan Line*, 441 U.S. at 450 (foreign "retaliation of necessity would be directed at American transportation equipment in general, not just that of the taxing state, so that the Nation as a whole would suffer"). The prospect of foreign retaliation serves to explain why a state tax may raise issues of national concern even when it is not imposed upon residents of other States. Threats of retaliation by foreign governments, however, cannot be sufficient *in themselves* to render a state tax invalid. Such a legal rule would in essence give foreign governments a "heckler's veto" over state taxing authorities. The rule would, moreover, encroach upon executive power by depriving the President of the authority to resist foreign demands when he considers resistance to be appropriate. Thus, in applying the "one voice" standard, foreign reaction cannot be dispositive in determining the propriety of a contested state tax.

The corollary to this proposition is that the political branches must be given primary responsibility for developing and articulating the foreign policy of the United States. As the Court observed in *Container Corp.*, "[t]his

Court has little competence in determining precisely when foreign nations will be offended by particular acts, and even less competence in deciding how to balance a particular risk of retaliation against the sovereign right of the United States as a whole to let the States tax as they please." 463 U.S. at 194. The second of these concerns is of particular importance. The factual question whether a particular state tax will precipitate foreign complaints, although far more expertly addressed by the political branches, is not wholly insusceptible of resolution through judicial proceedings. Questions concerning the federal government's proper response to such complaints, however, raise issues of foreign *policy* falling entirely outside the judicial ken.[13]

Thus, in applying the "one voice" test, the crucial question is whether the state action at issue is incompatible with federal policy as explicated by officials of the political branches.[14] We do not contend that executive branch personnel have the power to issue binding pronouncements declaring state taxing practices unconstitutional. In determining whether a state tax impairs the federal government's ability to speak with one voice, however, the Court must ascertain the contours of federal policies not codified in any statute or treaty; and in that process the statements of executive branch officials are entitled to substantial evidentiary weight.

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[13] "[M]atters relating 'to the conduct of foreign relations . . . are so exclusively entrusted to the political branches of government as to be largely immune from judicial inquiry or interference.'" *Haig* v. *Agee*, 453 U.S. 280, 292 (1981) (quoting *Harisiades* v. *Shaughnessy*, 342 U.S. 580, 589 (1952)). Cf. *Japan Whaling Ass'n* v. *American Cetacean Society*, 478 U.S. 221, 230 (1986).

[14] Similarly in *Boyle*, this Court did not attempt to determine by dint of its own expertise which state-law design requirements, if applied to military contractors, would impinge unduly upon the implementation of federal policy. Rather, the Court asked whether particular state-law requirements conflicted with contractual design specifications actually negotiated by federal procurement officials. See 487 U.S. at 509, 512.

The danger of improper encroachment on the President's conduct of foreign affairs, as noted above, is not limited to the situation where a State's method of taxation conflicts with an international understanding agreed to by the President or otherwise undermines the nation's international trade policies. Executive power is also improperly diminished when a court strikes down a state law on the basis of a foreign complaint that the President has determined to resist. Thus, in the absence of a dispositive statute or treaty, the courts must respect the judgments of the President regarding matters of foreign policy both where the President has determined that state compliance with an international norm is essential and where he has determined that foreign governments should not be allowed to dictate the practices of the States. The executive branch must be free in addition to adopt a middle ground: to acknowledge the validity of foreign concerns, and to attempt to persuade state officials to respond thereto, without insisting upon the States' immediate conformity with the federal norm. The courts therefore should not lightly infer a Foreign Commerce Clause violation from the mere fact that executive branch officials have attempted to persuade state authorities to alter their policies. Such an approach not only risks undue impairment of legitimate state prerogatives; it may also reduce presidential power by diminishing the executive's ability to employ "jawboning" and informal negotiation without invoking the specter of a constitutional confrontation.

b. In the past the Court has responded to these concerns partly by attaching special significance to the government's decision whether to file a brief amicus curiae in litigation brought by private taxpayers. See, *e.g., Container Corp.*, 463 U.S. at 195-196; *Itel Containers*, 113 S. Ct. at 1105. The Court has thus treated amicus participation by the United States as significant evidence of the state tax's likely effect on the federal government's ability to conduct foreign policy. This pronounced reluctance to invalidate state laws as violative of the "one voice" princi-

ple in the absence of an amicus submission by the federal government has helped to ensure both that legitimate state taxing choices are not unnecessarily precluded and that the Court does not unwittingly subvert the President's conduct of foreign economic policy.

c. There are, however, difficulties—both theoretical and practical—with this approach. It is highly unusual that a legal brief should be given (in effect) evidentiary weight in the very case in which it is filed. It is unusual as well to permit the introduction of evidence at the appellate stage of legal proceedings. The most serious problem, however, arises in suits (such as this one) seeking refunds of taxes collected during prior years.[15] A brief filed by the government in 1994 provides a clear indication of current executive branch policy. It is not entitled to the same weight, however, in determining what policy was in place in 1977. Inordinate reliance on the government's current policy can therefore present the risk that States will be held liable for refunds of taxes that violated no federal policy, and were thus in no way unlawful, at the time of their collection.

Our prior briefs in this case were flawed, we now believe, not in their discussion of the generally applicable legal principles, but because they failed adequately to consider the state tax's consistency with federal policy during the particular tax years in question. These briefs cited no executive branch pronouncements antedating President Regan's Statement of November 8, 1985. In contending that the state tax was contrary to the federal government's foreign commercial policy, we argued in the California Supreme Court that "[t]he adoption by the Federal Executive of this policy is evidenced by the letter of January 30, 1986, from the Secretary of State for the United States to the Governor of California." 92-1384 Pet. App. H-31. Similarly, our brief amicus curiae in

[15] Because of the Tax Injunction Act, 28 U.S.C. 1341, a Commerce Clause challenge to a State's taxing scheme is far more likely to reach this Court in the context of a suit for refund than in any other posture. See *Alcan Aluminium*, 493 U.S. at 338-341.

this Court at a prior stage of this case asserted that the California tax "prevents the United States from speaking with one voice on this sensitive and important matter" (92-212 U.S. Amicus Br. at 12-13), but did not examine the contours of federal policy as it existed in 1977—the tax year at issue.

A focus on current federal policy would be appropriate in a suit for declaratory or injunctive relief against *continued* imposition of a contested state tax. We now believe, however, that proper analysis of Barclays' *refund* claim requires a focus on federal policy during the tax year in question. Throughout this litigation the government has argued that a state tax violates the Foreign Commerce Clause if it is incompatible with an international standard to which the United States has committed itself by general agreement with its trading partners. We adhere to that view, which was accepted by this Court in *Japan Line*. To establish a constitutional violation, however, petitioner must show that the incompatibility existed prior to the accrual of the disputed tax liability.

Recent developments in related areas of the law make a precise focus on the contested tax year particularly important. Just last Term, this Court made clear that its decisions in civil cases must be given retroactive effect. *Harper* v. *Virginia Dep't of Taxation,* 113 S. Ct. 2510, 2517 (1993). *Harper,* together with *McKesson Corp.* v. *Division of Alcoholic Beverages & Tobacco,* 496 U.S. 18, 31, 39-41 (1990), also established that when a state tax is determined to have been unlawfully collected, the Constitution requires meaningful retrospective relief, ordinarily in the form of refunds. *Harper,* 113 S. Ct. at 2519-2520. These cases underscore the importance of a rigorous approach to the question whether a State tax was fatally inconsistent with federal foreign policy at the time the disputed tax liability accrued.

d. For the foregoing reasons, the Court's inquiry in the present case should focus on the federal government's

foreign economic policy as it existed in 1977.[16] In our view, no federal policy precluding the States' application of WWCR existed at that time.[17]

As of 1977, federal officials had not indicated that further use by the States of WWCR would be incompatible with a standard to which the United States was committed by general agreement with its trading partners. Rather, the sole executive branch initiative to constrain the States' use of the worldwide method was its negotiation of Article 9(4) of the United States-United Kingdom Tax Convention. In defending that provision, Treasury Department officials asserted that the arm's length approach was the more accurate method of distinguishing domestic from foreign income. These officials also emphasized, however, that Article 9(4) should be judged not in isolation, but as part of a larger agreement offering substantial advantages to the United States. Perhaps most significantly, executive branch officials gave assurances that in the event of the treaty's approval by the Senate, States could continue to apply WWCR to corporations controlled by other (*i.e.,* non-U.K.) foreign

[16] This case does not present the question whether California's taxing scheme was fatally inconsistent with federal policy during any year subsequent to 1977, and the United States accordingly does not address that question, which, in our view, should ultimately be resolved in accordance with the legal standards set forth in this brief.

[17] We do not suggest, of course, that this case is governed by Commerce Clause *jurisprudence* as it existed in 1977. *Harper* makes clear that principles of law announced by this Court after 1977 apply to Barclays' claim for refunds. See 113 S. Ct. at 2517. This Court's task, however, is to apply these legal principles to the *facts* —including, where pertinent, the contours of executive branch policy—as they existed when the disputed tax liability accrued.

Similarly, in applying the "government contractor" defense recognized in *Boyle,* a court's focus must be on government procurement specifications as they existed when the product at issue was manufactured. See 487 U.S. at 512. A contractor that complied with existing specifications could not be held liable on a theory of improper design simply because federal procurement policy had changed by the time the suit was finally resolved.

nationals, and that their right to do so would not be bargained away except in return for concessions from our trading partners.

Against this backdrop, executive branch actions prior to and during the tax year in question cannot accurately be viewed as manifestations of a then-existing federal policy requiring uniformity among the States. As of 1977, the executive branch had expressed a preference for the arm's length method and had proposed the adoption of a legal bar on the States' application of WWCR to *British*-controlled corporations. Surrounding events make quite clear, however, that the United States had not at that time acceded to any general international understanding regarding the impropriety of the worldwide method. To the contrary, during the 1977-1978 debates, executive branch officials expressly affirmed that States would remain free to apply WWCR to other foreign-controlled corporations even if the treaty were approved. California's application of WWCR to foreign-controlled corporations in 1977 therefore did not impermissibly intrude upon the federal government's conduct of foreign relations.[18]

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[18] Barclays also contends (92-1384 Pet. Br. 32-34) that California's application of WWCR to foreign-controlled multinationals creates a constitutionally impermissible risk of international double taxation. This Court held in *Container* that the risk of double taxation, though real, was not sufficiently grave to warrant invalidation of the WWCR method as applied to domestic corporations. 463 U.S. at 189-193. This Court reserved the question whether the tax could validly be applied to a foreign corporation, *id.* at 189 n.26, and noted that "[e]ven a slight overlapping of tax—a problem that might be deemed *de minimis* in a domestic context—assumes importance when sensitive matters of foreign relations and national sovereignty are concerned." *Id.* at 189 (quoting *Japan Line*, 441 U.S. at 456).

While the Court has sometimes appeared to treat double taxation and interference with federal foreign policy as separate dangers, see *Container Corp.*, 463 U.S. at 185-186, in fact in this context they are fundamentally intertwined. A level of double taxation that is constitutionally acceptable with respect to a domestic corporation could be deemed unacceptable with respect to a foreign taxpayer only on the ground that its application to foreign entities might trigger complaints or retaliation from other governments and hence disrupt our foreign commercial policy. Cf. *Japan Line*, 441 U.S. at 450-451. Since (as we demonstrate above) California's aplication of WWCR to foreign-controlled corporations in 1977 did not impermissibly intrude upon the federal government's conduct of foreign relations, Barclays' double taxation argument correspondingly fails.

3. Colgate-Palmolive Company, the petitioner in No. 92-1839, seeks refunds of taxes paid for the years 1970-1973. Colgate, a United States corporation, first argues that application of WWCR to domestic multinational corporations is impermissible because it impairs the federal government's ability to conduct foreign relations. Colgate contends that *Container Corp.* is not controlling because "[t]he missing evidence of the Executive Branch's opposition to worldwide combined reporting, which was crucial to the Court's decision in *Container*, has been supplied" (92-1839 Pet. Br. at 34) by subsequent executive branch pronouncements. In the alternative, Colgate contends that, even if application of WWCR to domestic corporations does not itself impair the conduct of foreign policy, a holding in Barclays' favor would require that the tax be invalidated as to domestic corporations as well, on the ground that application of different rules to domestic and foreign corporations "would seriously undermine the level playing field for different forms of protected commerce." *Id.* at 46. Colgate's claim should be rejected.

a. It is entirely clear that during the tax years in question there existed no federal policy against the States' application of WWCR to domestic corporations. Indeed, in 1976 the U.S.-U.K. Tax Convention was renegotiated in order to make clear that the treaty would *not* bar the States from applying WWCR to domestic corporations with British subsidiaries. As late as 1980, when the Treasury Department first expressed support for federal legislation barring the States from applying WWCR to foreign corporations, the Department noted that "[a]lthough the bill makes no distinction between corporate groups under

United States control and those under foreign control, such a distinction may be warranted." 92-1384 J.A. 588.[19] Application of WWCR to domestic corporations during the period at issue in this case therefore cannot be said to have "prevent[ed] the Federal Government from speaking with one voice in international trade." *Container Corp.*, 463 U.S. at 193 (citations and internal quotations omitted).[20]

b. As we have noted, see pp. 8, 11-12, the executive branch since 1982 has opposed the States' application of WWCR to domestic as well as foreign corporations. The executive has not asserted, however, that application of WWCR to domestic taxpayers interferes with the federal government's conduct of foreign relations. In submitting the Treasury Department's 1985 legislative proposal to Congress, Secretary Baker acknowledged that "the principal foreign commerce issues raised by state worldwide unitary taxation would be resolved if states were to agree that they would not impose worldwide unitary tax on foreign controlled entities." Baker letter at 2. The Secretary defended the scope of the proposed legislation (which would have barred the application of WWCR to both domestic and foreign taxpayers) not on foreign policy grounds, but as a means of preserving "competitive balance for domestic multinationals, foreign multinationals and purely domestic businesses in any resolution of the

[19] The Assistant Secretary of the Treasury for Tax Policy explained, in particular, that "the application of a unitary system to U.S. controlled corporate groups represents much less of an international irritant, if in fact that problem is present at all." 92-1384 J.A. 589.

[20] Colgate also argues that California's application of the unitary method violates a "clear federal directive" within the meaning of this Court's decision in *Container Corp.*, 92-1839 Pet. Br. at 34-36; see 463 U.S. at 194. This Court's analysis of the "clear federal directive" test in *Container Corp.* focused exclusively on pertinent *congressional* enactments, see *id.* at 196-197, and did not discuss executive branch pronouncements. In any event, Colgate has identified no pertinent executive branch pronouncement issued prior to or during 1970-1973, the tax years in question.

unitary issue." *Ibid.* Since that time the executive branch has continued to express the view that "[a]s a tax policy matter, we are equally opposed to the use of worldwide unitary apportionment to determine the income of domestic-parent multinational corporations and that of foreign-parent multinational corporations." 92-1839 J.A 35. The executive has not, however, asserted that application of WWCR to domestic corporations will impair the government's conduct of foreign relations, nor has the government participated in support of Colgate's constitutional claim at any stage of this litigation. Colgate therefore has wholly failed to show that California's application of the worldwide method to domestic taxpayers has "prevent[ed] the Federal Government from speaking with one voice in international trade." *Container Corp.*, 463 U.S. at 193 (citations and internal quotations omitted).

c. Finally, we believe that California's application of WWCR to Colgate should be upheld even if Barclays prevails in its legal challenge, since Colgate's "equal treatment" argument is without merit. The executive branch, we acknowledge, has previously expressed the view that divergent treatment of foreign and domestic taxpayers is undesirable as a matter of tax policy. Colgate cites no authority, however, holding that discrimination in favor of foreign taxpayers raises *constitutional* concerns under the Foreign Commerce Clause. The difference in treatment would be rationally justified by a finding that application of WWCR to foreign corporations has impaired the federal government's conduct of foreign economic policy and engendered frequent complaints by foreign nations, while application of this accounting method to domestic taxpayers has had neither of these consequences.[21]

[21] Taken to its logical conclusion, Colgate's argument implies that whenever a domestic taxpayer raises a Commerce Clause challenge to a state tax law, the reviewing court must determine whether that law could permissibly be applied to a foreign taxpayer, and must strike it down on "equal treatment" grounds if its application in the foreign context would be improper. That cannot be the law. Indeed, the whole point of *Japan Line* is that taxing practices that

4. For the foregoing reasons, we believe that the taxes at issue in these cases violated no federal policy and therefore were not unlawfully collected. If the Court holds otherwise, however, we believe it should make clear that in the unusual circumstances presented here—specifically, the recent modification of the State's taxing scheme—California is under no federal constitutional obligation to provide refunds.[22]

When a state tax is determined to have been unlawfully collected, "the Due Process Clause of the Fourteenth Amendment obligates the State to provide meaningful backward-looking relief to rectify any unconstitutional deprivation." *McKesson*, 496 U.S. at 31 (footnotes omitted). Accord *Harper*, 113 S. Ct. at 2519. Under some circumstances—as, for example, where the tax "was beyond the State's power to impose," *McKesson*, 496 U.S. at 39, or where "the taxpayers were absolutely immune from the tax," *ibid.*—the required remedy is a refund of taxes previously collected. In other situations, however,

are permissible with respect to domestic commerce are sometimes unlawful as applied to foreign commerce and/or foreign taxpayers.

[22] The supplemental brief filed by Barclays at the petition stage asserts that the United States, in its brief amicus curiae filed in October 1993, "completely omits any reference to the other six states that use worldwide combined reporting." 92-1384 Supp. Pet. Br. at 7. Although this statement was unsupported by statutory citations, petitioner's counsel of record has indicated that Alaska, Idaho, Montana, North Dakota, Tennessee, and Utah are the six States at issue. However, none of these States uses a WWCR system like the California system at issue here. In Utah, for example, WWCR is entirely elective for taxpayers. Utah Code Ann. §§ 59-7-304(3) (repealed effective 1/1/94) and 59-7-403 (effective 1/1/94) (1992 & Supp. 1993). Idaho, Montana, and North Dakota allow taxpayers to elect "water's edge" treatment in lieu of WWCR. Idaho Code 63-3027B (1989 & Supp. 1993); Montana Code Ann. §§ 15-31-322 to 15-31-326 (1993); North Dakota Century Code ch. 57-38.4-02 (1993). Alaska and Tennessee require WWCR only for certain sectors (oil and gas and financial institutions, respectively), Alaska Stat. § 43.20.073 (1990 & Supp. 1992) and Tennessee Code Ann. § 67-4-812(c)(1)(B) (1989 & Supp. 1993), and we are not aware of any objections expressed by the affected taxpayers.

the State "retains flexibility" to devise alternative adjustments that will cure the illegality, even if those adjustments do not involve the payment of money to the plaintiff taxpayer. *Ibid.*; *Harper*, 113 S. Ct. at 2519. Thus, where a state tax is found to have discriminated impermissibly against interstate commerce, "the State may assess and collect back taxes from [the taxpayer's] competitors who benefited from the rate reductions during the contested tax period, calibrating the retroactive assessment to create in hindsight a nondiscriminatory scheme." *McKesson*, 496 U.S. at 40.

In the present case, the tax at issue was not beyond the State's power to impose; it utilized a constitutionally fair method of apportioning income under this Court's decision in *Container Corp*. The petitioners were not immune from income taxation in California. Nor have petitioners suffered unlawful discrimination vis-a-vis some other class of taxpayers. Rather, the gravamen of petitioners' claim is that California's use of WWCR during prior years impaired the federal government's ability to conduct foreign commercial policy.

California's payment of money to the petitioners will not, of course, undo any disruption of federal government policy that may have already occurred. This is consequently a rare situation in which the provision of "meaningful backward-looking relief" is infeasible because the alleged constitutional injury—the impairment of the federal government's ability to conduct the nation's foreign policy—simply is not remediable by judicial order. A monetary remedy might nonetheless be appropriate if it appeared likely that the State's failure to provide refunds would itself become a subject of international contention or inspire reprisals from foreign governments. In light of the recent modification of California's tax scheme, however, the executive branch has concluded that the provision of refunds for past years is unnecessary to protect the federal government's present or future ability to speak in the future with one voice in international trade—*i.e.*, that California's prospective change suffices to eliminate

the basis for invalidating the taxes at issue. Indeed, the United Kingdom has deferred the implementation of retaliatory measures and has indicated that it will retaliate "only if it is found that the [1993 California] legislation is being applied in a way which exposes UK owned companies to damage from taxation that is inconsistent with the arm's length principle." 92-1384 Supp. Pet. Br. App. A-36. In these unusual circumstances, we believe that the Constitution imposes upon California no duty to provide a retrospective monetary remedy to corporate entities whose taxes were previously calculated on the basis of the worldwide method.

CONCLUSION

With respect to the questions discussed in this brief, the judgments of the court of appeal should be affirmed.

Respectfully submitted.

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In The

Supreme Court of the United States

October Term, 1993

BARCLAYS BANK PLC,
Petitioner,

v.

FRANCHISE TAX BOARD,
An Agency of the State of California,
Respondent.

On Writ of Certiorari to the Court of Appeal of the State of California for the Third Appellate District

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BRIEF FOR KEIDANREN (JAPAN FEDERATION OF ECONOMIC ORGANIZATIONS) AS AMICUS CURIAE IN SUPPORT OF PETITIONER

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December 15, 1993

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BRIEF FOR KEIDANREN (JAPAN FEDERATION OF ECONOMIC ORGANIZATIONS) AS AMICUS CURIAE IN SUPPORT OF PETITIONER

INTEREST OF THE AMICUS CURIAE

The Amicus is the Keidanren (Japan Federation of Economic Organizations), a private, non-profit organization representing all branches of economic activity in Japan and consisting of over 1000 members, 125 of which are trade associations and regional economic organizations, and the balance of which are leading Japanese corporations.[1] Many of the Japanese corporate members or their affiliates conduct business in the state of California either directly or through United States subsidiaries.[2] Many of these

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[1] All parties to this action have consented to the filing of this brief. Copies of the written consents have been lodged with the Clerk of the Court.

[2] Such Japanese-owned multinational corporate groups are referred to herein as "Japan-based Multinational Groups" and are included in the parallel term "Foreign-based Multinational Groups," as the context requires.

Japan-based Multinational Groups were subject to California's worldwide combined formula apportionment method (hereinafter the "Unitary Method") during the year in issue.

The interest of the Amicus differs from the interest of the Petitioner because of the decisive effect on the issue at bar of two treaties between the United States and Japan. These treaties are not applicable to United Kingdom residents such as the Petitioner. The first treaty is the "Convention Between the United States of America and Japan for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income" (the "U.S.-Japan Tax Treaty").[3] The second treaty is the "Treaty of Friendship, Commerce and Navigation Between the United States of America and Japan (the "U.S.-Japan FCN Treaty").[4] Both of these treaties were signed prior to the time California began applying the Unitary Method with respect to Foreign-based Multinational Groups.[5]

Although the Amicus believes that the decision of the California Supreme Court is incorrect and should be reversed, the Amicus believes also that these two treaties between the United States and Japan distinguish the Amicus' situation from that of the Petitioner. If this Court finds that the Unitary Method does not violate the Foreign Commerce Clause with respect to United Kingdom resident corporations because Congress' reservation in respect of Article 9(4) of the U.S.-U.K. Tax Treaty[6] constituted

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[3] 23 U.S.T. 967, T.A.I.S. No. 7365 (March 8, 1971).

[4] 4 U.S.T. 2065, T.I.A.S. No. 2863 (Apr. 2, 1953). Other nations have entered into Treaties of Friendship, Commerce and Navigation with the United States. These treaties are referred to herein as "FCN Treaties."

[5] *Barclays Bank Int'l Ltd. v. Franchise Tax Bd.*, No. 325059, Cal. Super. Ct. (Aug. 20, 1987) *reprinted in* Appendix A to Petitioner's Cert. Brief., at A-17.

[6] Convention Between the Government of the United States and the Government of the United Kingdom of Great Britain and Northern Ireland for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and Capital Gains (herein "U.S.-U.K. Tax Treaty"), 31 U.S.T. 5668, T.A.I.S. No. 9682 (Dec. 31, 1975).

Congress' acquiescence in the Unitary Method as applied to United Kingdom corporations, this Court should reserve on the issue of whether the same result should apply in the case of Foreign-based Multinational Groups that are entitled to protection provided by a different United States tax treaty. Further, a decision against Petitioner in this case should not control the issue of the Unitary Method's validity in the case of Japan-based Multinational Groups entitled to the benefits of the U.S.-Japan FCN Treaty because there is no FCN Treaty between the United Kingdom and the United States and the U.S.-Japan FCN Treaty proscribes application of the Unitary Method.

ISSUES ADDRESSED BY THE AMICUS CURIAE

Whether the basis for the California Supreme Court's finding Congressional approval of the Unitary Method and upholding the constitutionality of the Unitary Method as applied to Foreign-based Multinational Groups was fatally flawed? If so, whether a correct analysis leads to the conclusion that the Unitary Method, as applied to Foreign-based Multinational Groups, is unconstitutional under the Foreign Commerce Clause, because the Unitary Method results in double taxation and prevents the Federal Government from speaking with "one voice when regulating commercial relations with foreign governments," as evidenced by recent foreign government retaliation against the United States in response to continued use of the Unitary Method? If not, whether the issue nevertheless should be reserved as to whether a different result is appropriate in the case of Japan-based Multinational Groups entitled to the protections of the U.S.-Japan Tax Treaty and the U.S.-Japan FCN Treaty?

INTRODUCTION AND SUMMARY OF ARGUMENT

Under the Unitary Method, Japanese and other foreign parent corporations are required to file a combined return with all of their worldwide subsidiaries (the "combined report"). A portion of the

total worldwide income of the combined group is then allocated to California under a "three-factor formula" apportionment method that is based on the proportion of property, payroll and sales in the taxing state compared to the same factors of the worldwide consolidated group.[7] Under California's Unitary Method, corporations that are more than fifty percent foreign-owned are included in the combined report without regard to whether they have (i) engaged in business in California or elsewhere in the United States, (ii) derived income from sources within California or elsewhere in the United States, or (iii) engaged in any transactions with a related corporation incorporated in California or elsewhere in the United States.[8]

The Unitary Method is fundamentally different from and irreconcilable with the arm's length standard and the separate entity accounting method (the "arm's length method"). The arm's length method is the international standard universally used and accepted by the nations of the world and by multinational corporations. It is the method required by United States tax treaties, FCN treaties and the Internal Revenue Code. The arm's length method treats each corporation as "an independent entity dealing at arm's length with its affiliated corporations, and subject to taxation only by the jurisdictions in which it operates and only for the income it realizes on its own books." *Container Corporation of Am. v. Franchise Tax Bd.*, 463 U.S. 159, 185 (1983). In the international context, the arm's length method allocates income to a single taxing jurisdiction rather than arbitrarily apportioning the income among jurisdictions, and treats intercorporate transfers of value between commonly controlled entities in accordance with the terms that would have been obtained

[7] *See* CALIF. REV. & TAX CODE §§ 25128-25136 (West 1992).

[8] Under legislation enacted in 1986 (and effective in 1988), California provided corporations with a "water's edge" election to avoid application of worldwide formulary apportionment to income of their foreign affiliates and parents. *See* CAL. REV. & TAX CODE § 25110 (West 1992). California further limited the obligation to use the Unitary method in October 1993. Because the year in issue is prior to the legislative changes, we have not addressed whether these changes "cure" the constitutional defects of the Unitary Method.

had such transfers occurred between uncontrolled entities in similar circumstances.[9]

In *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274, 279 (1977), this Court found that if a state tax "is applied to an activity with a substantial nexus with the taxing state, is fairly apportioned, does not discriminate against interstate commerce, and is fairly related to the services provided by the State," no impermissible burden on interstate commerce will be found. In *Japan Line, Ltd. v. County of Los Angeles*, 441 U.S. 434, 451 (1979), this Court identified two additional criteria under the Foreign Commerce Clause for testing the validity of a state tax affecting foreign commerce. A state tax will violate the Foreign Commerce Clause, notwithstanding its compliance with the four criteria in *Complete Auto Transit*, if it "creates a substantial risk of international multiple taxation" or "prevents the Federal Government from 'speaking with one voice when regulating commercial relations with foreign governments.'"

In *Container*, this Court held that California's Unitary Method did not violate the Foreign Commerce Clause when applied to United States-owned domestic corporations with foreign subsidiaries ("U.S.-based Multinational Groups"). However, the *Container* opinion specifically reserved on the issue of whether California's Unitary Method violated the Foreign Commerce Clause as applied to Foreign-based Multinational Groups.[10]

In *Wardair Canada Inc. v. Florida Department of Revenue*, 477 U.S. 1 (1986), this Court upheld Florida's aviation fuels tax as applied to Canadian air carriers engaged in international commerce. The carrier and the United States had conceded that no risk existed of multiple taxation so that only the "one voice"

[9] The power to enforce such treatment by allocating income among related parties and jurisdictions under the arm's length method is established by section 482 of the Internal Revenue Code, 26 U.S.C. § 482, and the Associated Enterprises article of United States tax treaties.

[10] *Container*, 463 U.S. at 189 n.26, 195 n.32.

test under *Japan Line* was applicable. The Court found it dispositive under this test that while a United States-Canada aviation treaty (and other similar treaties) were silent on limiting state taxation of aviation fuel, the Federal Aviation Act expressly permitted the states to tax such fuels.

In the case below, the California Supreme Court concluded that *Wardair* had "reoriented" dormant Foreign Commerce Clause analysis so as to make such analysis inappropriate in this case. Specifically, the California Supreme Court cited a number of "negative implications" that it believed were created by United States Senate or Congressional actions. The California Supreme Court relied on these alleged "negative implications" to support its conclusion that Congress had in effect affirmatively approved of the Unitary Method.[11] Among the actions from which the California Supreme Court extracted these "negative implications" were the Senate's reservation to Article 9(4) of the U.S.-U.K. Tax Treaty, the Senate's ratification of other United States tax and FCN treaties, and Congress' enactment of certain provisions of the Internal Revenue Code, particularly section 482.

The California Supreme Court's interpretation and analysis are incorrect. In fact, the Unitary Method, when applied to Foreign-based Multinational Groups such as the Petitioner herein, is completely irreconcilable with the relevant provisions of United States tax and FCN treaties, as well as the Internal Revenue Code.

In addition, the taxation of a Foreign-based Multinational Group's income demands that the Federal Government speak with "one voice" to foreign governments. The failure to find the Unitary Method violative of the Foreign Commerce Clause will result in our treaty partners hearing "many voices" on the issue of the appropriate taxation of Foreign-based Multinational Groups. All treaty jurisdictions must follow the internationally agreed norm of the arm's length method as embodied in tax treaties in order for multinational corporations to engage in international commerce and

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[11] 829 P.2d 279, 295 (1992).

avoid multiple taxation of the same income. Further, while certain practical problems may exist with the application of the arm's length method, *only* the arm's length method makes possible a mechanism to prevent double taxation—the Competent Authority procedures contained in United States tax treaties.

If this Court finds California's Unitary Method constitutional when applied to United Kingdom-based Multinational Groups, this Court should nevertheless reserve on the issue of whether the same interpretation applies to Japan-based Multinational Groups entitled to the protections of the U.S.-Japan Tax Treaty and the U.S.-Japan FCN Treaty.

ARGUMENT

I. THE CALIFORNIA SUPREME COURT'S RELIANCE UPON UNITED STATES TAX TREATIES AS SUPPORTING THE UNITARY METHOD IS INCORRECT.

In upholding the Constitutionality of California's Unitary Method, the California Supreme Court cited two instances of Senate *inaction* in the tax treaty context which the court believed created decisive "negative implications." Based upon these "negative implications," the court concluded that Congress had affirmatively approved the Unitary Method. As the opinion stated, paraphrasing *Wardair*:

> [I]nternational agreements demonstrate that the Federal government has affirmatively acted, rather than remained silent, with respect to the power of the states to employ formula apportionment in so-called foreign parent cases.[12]

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[12] 829 P.2d at 294.

According to the California Supreme Court's opinion, the "din of 'governmental silence' that cannot be ignored"[13] was evidenced by two treaty-related phenomena. First, the court found it decisive that United States tax treaties uniformly obligate the Federal Government to utilize the arm's length method, but uniformly *exclude* the state governments from all treaty obligations except those contained in the non-discrimination article. Second, the court found decisive the Senate's lodging of a reservation to Article 9(4) of the U.S.-U.K. Tax Treaty, which would have prohibited the states' use of the Unitary Method with respect to U.K.-based Multinational Groups.

Based in significant part on these "negative implications" the California Supreme Court ruled that the case at bar was not an appropriate case for dormant Foreign Commerce Clause analysis, because that analysis "'only operates where the Federal Government has not spoken.'"[14] According to the court, in this case, the Federal Government had indeed spoken and had approved the states' use of the Unitary Method.

The ensuing sections of this brief address why the California Supreme Court's analysis is wrong, why such analysis should not be applied in any event under earlier tax treaties (such as the U.S.-Japan Tax Treaty), and why the correct analysis leads inescapably to the conclusion that the arm's length method must prevail over the Unitary Method.

A. The California Supreme Court's Interpretation That Congressional Silence on State Taxation in United States Tax Treaties Negatively Implies Congress' Acquiescence in the Unitary Method Is Incorrect.

The California Supreme Court noted that the "bilateral income tax treaties negotiated by the United States with many of its trading partners typically prescribe use of the [arm's length] method by the

[13] *Id.*

[14] 829 P.2d at 293 (*quoting Wardair*, 477 U.S. at 12).

signatory governments" but "they do not ... impose such a requirement on taxation by subnational levels of government."[15] Because subnational levels of government are included for purposes of the nondiscrimination article, the California Supreme Court concluded that:

> We think this latter evidence substantially parallels the *Wardair* paradigm, where the high court concluded that the "negative implications" arising from the Convention's limited ban on state taxation of fuel "on board" arriving foreign aircraft demonstrated an awareness of subnational taxation issues and represented "a decision by the parties ... to address the problem by curtailing and limiting only some of the localities' power to tax, while implicitly preserving other aspects of that authority."[16]

The convention referred to was the Convention on International Civil Aviation.[17] This Court found that Article 24(a) of that convention "by its terms precluded the imposition of local taxes on fuel only when the fuel is 'on board an aircraft ... on arrival ... and retained on board on leaving' a contracting party."[18] In *Wardair* this Court found direct language contained in an international agreement that limited a state's power to tax. This Court found that the negative implication of this limitation was Congress' approval of state taxation that was not directly proscribed in the agreement.

In the case at bar, the California Supreme Court, citing the absence of any explicit tax treaty limit on the power of states to tax (except that the states not discriminate), found such Federal Government silence on state taxation to be evidence of the Federal

[15] 829 P.2d at 298.

[16] *Id.*

[17] *open for signature* Dec. 7, 1944, art. 24(a), 61 Stat. 1180, 1186, 3 Bevans 944, 950.

[18] *Wardair*, 477 U.S. at 10.

Government's affirmative acquiescence in state use of the Unitary Method. Such an interpretation goes far beyond *Wardair's* "negative implications," and elevates silence on an issue to a new level of communication.

The conclusion of the California Supreme Court overlooks a far simpler explanation for the exemption of state taxes from the tax treaties: the general principle of state sovereignty. Both the Federal Government and the states have concurrent taxing powers.[19] The Federal Government is cognizant of the friction caused by the Federal Government's Foreign Commerce Clause power and state taxing sovereignty. In that regard, the Executive Branch has not seen fit to regulate states' taxation authority until the state tax laws cause international concerns.[20]

Further, respecting the states' sovereignty over taxation, while attempting to provide coverage for state taxation within the scope of United States tax treaties, is unworkable. The United States cannot negotiate a treaty with 50 additional participants at the table. Moreover, not covering state taxes in the treaties was never intended to give the states free and unfettered license to tax in a way that conflicts with federal taxation principles the same international parties and transactions as are covered by the treaties. Such an approach would effectively frustrate the very purpose of the tax treaty to harmonize national systems and prevent double taxation.

The California Supreme Court's reliance upon the exclusion of state taxes from United States tax treaties—a recognition of our federal system—as the Federal Government's affirmative approval

[19] *Hines v. Davidowitz*, 312 U.S. 52, 68 (1941); The Federalist No. 32 (Alexander Hamilton).

[20] Following California's adoption of the Unitary Method and this Court's decision in *Container*, the Executive Branch has repeatedly studied and proposed measures to restrict the application of the Unitary Method to Foreign-based Multinational Groups. *See generally Colgate-Palmolive Co., Inc. v. Franchise Tax Bd.*, 4 Cal. App. 4th 1681, 1701-8 (1991) *vacated and remanded*, 831 P.2d 798 (Cal. 1992).

of the Unitary Method cannot be supported. The Federal Government's silence on state taxation issues cannot overcome its loud voice in support of the arm's length method as expressed in and through the tax treaty network.

B. The Failure of Congress to Adopt the U.S.-U.K. Tax Treaty Without the Limitation on State Taxation Contained in Article 9(4) Cannot Be Interpreted as Congress' Acceptance of the Unitary Method.

As detailed in the opinions in the case below, Article 9(4) of the U.S.-U.K. Tax Treaty explicitly limited Federal and state taxation to the arm's length method. The Treaty, signed in 1975, was one of the first treaties negotiated after California enacted the Unitary Method.

When the Treaty was considered by the Senate Foreign Relations Committee, Senator Frank Church introduced a reservation to Article 9(4). The reservation provided "that the provisions of paragraph (4) of Article 9 ... shall not apply to any political subdivision or local authority of the United States."[21] When voted on in committee, the reservation was rejected 10 to 5. On the Senate floor, the reservation was again defeated by a vote of 44 to 34. The Treaty as signed then received a vote of 49 to 32, five votes short of the two-thirds needed. Thereafter, Article 9(4) was reserved without a vote and the treaty was ratified with the reservation. The reservation was effectuated by the Third Protocol to the U.S.-U.K. Tax Treaty.

The California Court of Appeals appropriately stated that it "fail[ed] to see how three majority votes in the Senate essentially approving article 9(4) could be transmogrified into a *congressional policy* of disapproval" of the treaty provision.[22] The Court of Appeals also noted that the opposition to the treaty-based

[21] 124 Cong. Rec. 18416 (1978).

[22] *Barclays Bank Int'l, Ltd. v. Franchise Tax Bd.*, 3 Cal. App. 4th 1034, 1055 (1990).

restriction was not rooted in the substance of the article, but was instead reflected in certain Senators' opposition to dealing with this problem on a piecemeal basis instead of by comprehensive legislation.[23] Legislation that would restrict the states' ability to use the Unitary Method has been introduced in Congress,[24] but has never reached a vote in committee or on the floor.[25]

The California Supreme Court wrongly concluded that Congress' adoption of the U.S.-U.K. Tax Treaty with the reservation as to Article 9(4) reflected Congress' affirmative

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[23] In fact, Senator Howard Baker stated:

> In adopting its reservations to Article 9(4) in June of 1978, the Senate appeared to reach a consensus that domestic legislation, as an alternative to international treaty language, is preferable in regulating that conduct of the States which may affect foreign commerce.
>
> * * *
>
> [T]he States may incorrectly interpret the Senate's reservation to Article 9(4), and the Third Protocol to this Convention, as an invitation to establish policies applicable to foreign source income which are inconsistent or incompatible with broad National tax policies.

Committee on Foreign Relations, Rep. on the Third Protocol to the 1975 Income Tax Convention with the United Kingdom of Great Britain and Northern Ireland, as Amended, Exec. Rep. No. 5, 96th Cong., 1st Sess. 15 (1979).

[24] It should also be noted that none of these bills dealt solely with restricting the states' ability to use the Unitary Method. Therefore, Congress' inaction could be the result of an entirely unrelated provision in those bills.

[25] *Barclays Bank Int'l, Ltd. v. Franchise Tax Bd.*, 3 Cal. App. 4th at 1054. The California Supreme Court used this lack of action on these bills as further evidence of Congress' acquiescence in the Unitary Method. 829 P.2d at 296. If *inaction* on the part of Congress is correctly interpreted as *action* on the opposite point, then Congress' failure to vote on the Foreign Income Tax Rationalization and Simplification Act of 1992, H.R. 5270, 102d Cong., 2d Sess., which would have required a foreign-owned corporation engaged in substantial related party transactions to report a minimum formulary amount of taxable income, should be interpreted as evidence of Congress' affirmation that formulary methods that deviate from the arm's length standard are inappropriate. We are not necessarily advocating this position; we simply believe Congress' silence should be interpreted as that—silence.

approval of the Unitary Method, thereby removing this case from a dormant Foreign Commerce Clause analysis. A reservation is not an affirmative statement.

The California Supreme Court's interpretation is inconsistent with the intent of both Congress and the United Kingdom Government. Given the majority votes in favor of the original treaty provision, and the ~~various~~ reasons Senators may have voted for the treaty with the reservation, it is impossible to conclude as a factual matter that Congress intended to authorize the Unitary Method. Similarly, given the United Kingdom's outspoken opposition to the Unitary Method, it is impossible to interpret Congress' reservation as the *United Kingdom's* acceptance and approval of the Unitary Method.

The California Supreme Court's interpretation of the treaty reservation is completely at odds with this Court's standards for treaty interpretation: "Like other contracts, [treaties] are to be read in the light of the conditions and circumstances existing at the time they were entered into, with a view to effecting the objects and purposes *of the states* thereby contracting."[26] The only interpretation consistent with the intent of both parties is that the reservation nullified the provision.

If the California Supreme Court's interpretation of the reservation to Article 9(4) is approved by this Court, such approval will establish an entirely new standard for treaty interpretation. Such standard would allow the courts of the United States to interpret treaty provisions in a manner wholly inconsistent with the intent of the treaty partner. Therefore, such a standard

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[26] *Rocca v. Thompson*, 223 U.S. 317, 331-32 (1912) (emphasis added). This rule of treaty construction has been adopted by many other courts. *See Maximov v. United States*, 299 F.2d 565, 568 (2d Cir.) (The objective is to "give the specific words of a treaty a meaning consistent with the genuine shared expectation of the contracting parties.") *aff'd*, 373 U.S. 49 (1963); *Johansson v. United States*, 336 F.2d 809, 813 (5th Cir. 1964); *Estate of Burghardt v. Commissioner*, 80 T.C. 705, 708 (1983); *Aiken Indus., Inc. v. Commissioner*, 56 T.C. 925, 933 (1971).

will attract widespread international protest, and could ultimately impair the ability of the Executive Branch to negotiate and conclude treaties.

C. Even If This Court Accepts the California Supreme Court's Interpretation of the Ratification of the U.S.-U.K. Tax Treaty with the Reservation to Article 9(4), Such Interpretation Should Have No Effect upon a Tax Treaty (Such as the U.S.-Japan Tax Treaty) Adopted Prior to California's Adoption of the Unitary Method.

Taxpayers entitled to the protections of treaties negotiated and signed *prior* to California's adoption of the Unitary Method, such as Japan-based Multinational Groups, should not be held to any "negative implication" of Congress' reservation with respect to Article 9(4) of the U.S.-U.K. Tax Treaty. Tax treaty negotiations are bilateral negotiations. The Japanese government and the United States Government negotiated their treaty *prior* to California's adoption of the Unitary Method. Japan had no reason to request a provision requiring the states to use an arm's length method when that was the method already generally employed by the states in taxing Japan-based Multinational Groups.

The Senate's reservation to Article 9(4) and the adoption of the Third Protocol to the U.S.-U.K. Tax Treaty by the United Kingdom Parliament should in no way be binding on treaties negotiated prior to California's adoption of the Unitary Method. If this Court should rule that the Senate's reservation with regard to Article 9(4) of the U.S.-U.K. Tax Treaty results in a negative implied approval of the Unitary Method, this Court should reserve on the issue of whether that reservation has a similar effect on corporations entitled to benefits under treaties that pre-date both the Senate's vote and California's adoption of the Unitary Method.

D. Uniformity in the Taxation of Foreign-based Multinational Groups Is Essential in Order for the Federal Government to Speak with One Voice Through the United States Tax Treaty Network and in Order to Prevent Double Taxation.

The California Supreme Court never addressed the *Japan Line* tests of Foreign Commerce Clause analysis (namely, the "one voice" and multiple taxation tests). The Amicus believes that the California Supreme Court's analysis is incorrect, and that this Court should apply the *Japan Line* "one voice" and double taxation tests.

With regard to the "one voice" test, the extraordinary consensus of nations regarding the arm's length method, as embodied not only in the United States tax treaty network but in the tax treaty networks of virtually all other countries (both developed and developing), attests to the importance of permitting the United States to speak with "one voice," rather than 50 or more voices. Thus, the California Superior Court found as a factual matter that:

> There is an international standard of accounting universally practiced by all nations of the world, including the United States, the AL/SA [Arm's Length/Separate Accounting] method. It is used to determine income of business entities derived from operations in countries other than their own, for purposes of income taxation by those countries. It operates on the assumption that only the income actually earned within a foreign country should be taxed by it (no double taxation), but because that cannot always be determined with exactitude, AL/SA uses formulary allocations when and as needed. But it is indisputable that its aim is to determine as closely as possible what actual income is derived from activities within the geographical boundaries of the taxing nation, and tax that income only.

As the above-quoted finding suggests, the country-by-country approach to determining "actual income" derived from and taxable by each country is a unique hallmark of the arm's length method which, in part because the method respects geographic boundaries (and national sovereignty), is the sole internationally accepted method.[27] The method is deeply ingrained in the prevailing OECD and U.N. Model Treaties which are the starting points for the negotiation of new or revised bilateral treaties. Such method is the main foundation of common ground upon which national tax systems (and in many instances subnational tax systems) are harmonized in and through tax treaties. It requires only the most summary view of how United States tax treaties determine tax jurisdiction under the separate country arm's length method to see how any material departure from this method, such as California's application of the Unitary Method to Foreign-based Multinational Groups, could disrupt treaty relationships and cause multiple taxation.

There are two bases on which the treaties permit taxation to be exercised—source and business presence. First, source-based taxation is predicated upon certain types of income derived from sources within the paying country being subject to a limited tax based on the gross amount of the payment. Some treaties exempt certain of these payments entirely from taxation by the source country. The purpose of the reduced or zero taxation is to foster the free flow of capital into the nation of the payor of the income.

Second, the United States may generally tax a corporation, resident in a treaty partner country that earns "business profits" in the United States if the corporation maintains a "permanent establishment" in the United States. In general, a permanent establishment is defined under most treaties as a fixed place of business through which the business of an enterprise is wholly or

[27] The arm's length method may be considered a "custom of nations." *See Colgate-Palmolive Co., Inc. v. Franchise Tax Bd.*, 4 Cal. App. 4th 1681, 1710 (1991) *vacated and remanded*, 831 P.2d 798 (Cal. 1992); American Law Institute, INTERNATIONAL ASPECTS OF UNITED STATES INCOME TAXATION II: PROPOSALS ON UNITED STATES INCOME TAX TREATIES, 2-10 (1991).

partly carried on.[28] Under the permanent establishment articles, minor actions taken in the United States, *e.g.* auxiliary or preparatory activities, or merely holding the stock and overseeing United States subsidiary corporations, will not rise to the level of a permanent establishment,[29] *i.e.*, income from these activities will not be taxable. The "permanent establishment" standard, as agreed by the international community, is a more difficult nexus test than the "flow of value"[30] test required to include a foreign corporation in the Unitary Method's "combined report."

The treaties also provide mechanisms to ensure that the amount of net income reported in each treaty partner country in connection with inter-branch or inter-company transactions with the multinational group is properly determined under the arm's length method. Thus, the "business profits" articles of United States tax treaties contain an arm's length independent entity standard for determining the taxable income of a permanent establishment. Similarly, the Associated Enterprises articles of United States tax treaties allow either treaty partner to allocate profits from a corporation to a related corporation in the other country to the extent necessary to ensure that the transactions are on an arm's length basis. If related parties engage in non-arm's length transactions, the treaties do not necessarily prohibit the use of a formulary method to place the transaction on an arm's length basis. However, any allocation of income from a United States corporation to a related foreign corporation, regardless of the method utilized, is only permitted to the extent there are actual transactions between related parties and such transactions have been conducted on a non-arm's length basis.

[28] Organization for Economic Cooperation and Development, Model Tax Convention on Income and on Capital, art. 5 (1992) (hereafter "OECD Model Treaty"). *See also* U.S.-U.K. Tax Treaty, Article 5; U.S.-Japan Tax Treaty, Article 9 ("a fixed place of business through which a resident of a Contracting State engages in industrial or commercial activity").

[29] *Ibid.*

[30] *Container Corp. of Am. v. Franchise Tax Bd.*, 463 U.S. 159, 178 (1983).

While the specific rules implementing the foregoing concepts may differ somewhat from country to country, the concepts and the framework on which they operate are universally accepted. On the other hand, the Unitary Method is inconsistent with the foregoing internationally agreed norms of taxation contained in the treaties. The Unitary Method determines income attributable to California by including all of the worldwide income of the unitary group, without regard to the fact that a large portion of that income has its source *outside* California, and in fact *outside* the United States.

The Unitary Method includes all of the income of a Foreign-based Multinational Group into the "pool" of income from which California allocates a portion to the state, even if the foreign parent and affiliate have *no* United States source income, are *not* engaged in a trade or business in the United States through a permanent establishment, and do not engage in non-arm's length transactions with related parties in the United States. United States tax treaties uniformly concede tax jurisdiction in respect of this income to the foreign treaty partner jurisdiction. Unless the foreign jurisdiction has a zero percent tax rate, double taxation will result when California taxes this income.

The Unitary Method further violates the underlying principles of international taxation embodied in United States tax treaties by allocating the income of a foreign parent and its foreign subsidiaries to the parent's United States subsidiary. United States tax treaties do not allow the United States to tax the income of a foreign parent corporation merely because its subsidiary is engaged in business in the United States. Similarly, while the United States provides for certain deemed inclusions from subsidiaries to the parent,[31] a deemed inclusion from a parent to its subsidiary is without precedent where the parties are otherwise dealing with one another on an arm's length basis. Without a finding of non-arm's length transactions, the Unitary Method's combination of the income of a foreign parent (and its other foreign subsidiaries) with

[31] *See* Subpart F, 26 U.S.C. §§ 951-964.

the income of a corporation engaged in business in the United States is without foundation or justification under the internationally accepted norms contained in tax treaties.

The fact that the Unitary Method is fundamentally inconsistent with the arm's length method embodied in the treaties has already attracted international protest and retaliation. Most significantly, if the Unitary Method were upheld, as applied to Foreign-based Multinational Groups, it would interfere with and disrupt the Federal Government's ability to negotiate and conclude future tax treaties. Accordingly, the Amicus submits that the need for federal uniformity in this area is compelling and that the Unitary Method should be held suspect under the "one voice" test.

Under the second *Japan Line* test relating to multiple taxation of the same income, the Unitary Method also must fail because it provides no method for eliminating such double taxation. Because the Unitary Method taxes a California corporation on an amount determined by a formula to be California taxable income without regard to whether such income is also being reported as the income of a foreign affiliate for foreign tax purposes, instances of double taxation almost certainly will occur. Double taxation will always occur where, under international normative rules as embodied in United States tax treaties, the income taxed by California is reserved for taxation by a treaty partner. The Unitary Method, however, provides no mechanism to relieve this double taxation.[32] On the other hand, the arm's length method does provide such a system to relieve international double taxation.

[32] *Compare Itel Containers Int'l Corp. v. Huddleston*, 122 L. Ed. 2d 421, 436 (1993), where this Court recognized that Tennessee's provision of a credit for foreign or domestic taxes paid on the same transaction to which Tennessee was levying its tax, reduced, if not eliminated, the risk of international multiple taxation. It should be noted that California has no such foreign tax credit mechanism.

The Associated Enterprises or Mutual Agreement article of most United States tax treaties contains a provision similar to the following provision from the OECD Model Treaty:[33]

> Where a Contracting State includes in the profits of an enterprise of that State—and taxes accordingly—profits on which an enterprise of the other Contracting State has been charged to tax in that other State and the profits so included are profits which would have accrued to the enterprise of the first mentioned state if the conditions made between the two enterprises had been those which would have been made between independent enterprises, then that other State shall make an appropriate adjustment to the amount of tax charged therein on those profits. In determining such adjustment, due regard shall be had to the other provisions of this Convention and the competent authorities of the Contracting States shall if necessary consult each other.

The competent authorities referred to are authorized by the Mutual Agreement articles of United States tax treaties to endeavor to resolve disputes between the two states relating to, among other things, the taxation of transactions between related parties and the prevention of double taxation.

The availability of the competent authority procedure, and of the correlative adjustment mechanism to ensure consistent treatment of intercompany transactions in both jurisdictions, substantially reduces the risk of double taxation. California has no mechanism available to a taxpayer subjected to double taxation caused by the Unitary Method.

This Court has noted that California, because it is *not* a party to United States tax treaties and is *not* authorized by the constitution to negotiate its own tax treaties, may not avail itself

[33] OECD Model Treaty, Article 9(2). *See also* U.S.-Japan Tax Treaty, Article 25(2); U.S.-U.K. Tax Treaty, Article 9(3).

directly of this competent authority process.[34] However, California may receive information from the United States regarding competent authority negotiations and adjustments made to a taxpayer's transfer prices as a result of competent authority negotiations.[35] If California required taxpayers to use the same intercompany prices as reflected on their federal returns, and to amend those returns if any adjustment was made (either by the IRS or the competent authorities), California could effectively eliminate the risk of double taxation.

The competent authority process has proven effective. In addition, there are procedures either in place or pending with many of our treaty partners to enter into bilateral "advance pricing agreements" relating to particular taxpayers, whereby the competent authorities agree on a correct intercompany pricing methodology on a prospective basis. This procedure, also only available under treaties, may further reduce the incidence of double taxation.

Because no mechanism whatever exists to prevent or relieve the multiple taxation resulting from application of the Unitary Method to Foreign-based Multinational Groups, the Unitary Method fails the second *Japan Line* test by creating a substantial risk of multiple taxation.

II. THE CALIFORNIA SUPREME COURT'S RELIANCE UPON PROVISIONS OF THE INTERNAL REVENUE CODE AS SUPPORTING THE UNITARY METHOD IS INCORRECT.

The notion that section 482 of the Internal Revenue Code supports the Unitary Method is preposterous. Yet, the California

[34] *Container*, 463 U.S. at 192 n.31.

[35] 26 U.S.C. § 6103(d) provides that returns and return information shall be open for inspection by, or disclosure to "any State agency, body or commission, or its legal representative, which is charged under the laws of such State with responsibility for the administration of State tax laws...."

Supreme Court's opinion cites the term "apportion" in section 482 as evidence that Congress in effect has long sanctioned state application of the Unitary Method. According to the opinion:

> [I]n enacting the Internal Revenue Code of 1956, Congress authorized the Secretary of the Treasury to "distribute, *apportion*, or allocate gross income ... between or among" multi-corporate enterprises, including those with foreign domiciles, "in order ... clearly to reflect [their] income" (26 U.S.C. § 482, italics added), a formulation that reflects at least an awareness of apportionment methodologies.[36]

The implication of the above-quoted passage is that Congress had knowledge of "apportionment methodologies" similar in concept to the Unitary Method and, far from prohibiting or limiting their use, actually endorsed their use to allocate income under section 482.

The proposition that the term "apportion" in section 482 had anything to do with a formulary, non-separate accounting concept similar to the Unitary Method is clearly wrong. The California Supreme Court's error is based on a misunderstanding of the legislative history of section 482. That history demonstrates Congress' overriding objective to prevent abuses involving the use of intercompany transactions to avoid tax by placing income improperly in a tax-favored entity and/or a tax-favored country. Congress authorized the IRS to correct such misallocations of income by reallocating the income back to the entity or country where it properly belonged. Only the arm's length method contemplates and provides for such entity-by-entity and country-by-country allocation. Because the Unitary Method is totally indifferent to whether income properly "belongs in" or is properly earned by or within any particular entity or country, Congress could not possibly have had a Unitary Method in mind when it

[36] 829 P.2d at 297.

originally enacted the predecessor of section 482. A brief review of the legislative history confirms this Congressional focus.

The antecedent of section 482 was contained in regulations promulgated under the authority of the Revenue Act of 1917 which required affiliated corporations to provide sufficient information about intercorporate relationships that would allow the Commissioner "to compute the amount of the tax properly due from *each* corporation on the basis of an equitable and lawful accounting."[37] In addition, the regulations generally authorized the Commissioner to allocate income and deductions among affiliated corporations and also to consolidate the accounts of such affiliated corporations "whenever necessary to more equitably determine the invested capital or taxable income...."[38] This authority to "consolidate accounts" was continued in section 240 of the Revenue Act of 1918.[39] The Senate Committee on Finance Report explained that such "consolidation ... prevent[s] evasion which cannot be successfully blocked in any other way. Among affiliated corporations it frequently happens that the accepted intercompany accounting assigns too much income ... to Company A [and] not enough to Company B."[40]

Section 240(d) of the Revenue Act of 1921 similarly authorized the Commissioner to "consolidate the accounts of ... related trades and businesses, in any proper case, for the purpose of making an accurate distribution or apportionment of gains, profits, income, deductions, or capital between or among such related trades or businesses."[41] The House Ways and Means Committee clarified that the provision's purpose was to prevent

[37] Reg. 41, art. 77, T.D. 2694 (1918) (emphasis added).

[38] Reg. 41, art. 78, T.D. 2694 (1918). *See Union Pac. R.R. v. Commissioner*, 17 B.T.A. 793 (1929), *acq.*

[39] ch. 18, § 240, 40 Stat. 1057.

[40] S. Rep. No. 617, 65th Cong., 3d Sess. 8-9 (1918).

[41] ch. 136, § 240(d), 42 Stat. 227.

arbitrary profit-shifting and other abuses, such as the use of a foreign subsidiary to "milk" the parent corporation "or otherwise improperly manipulate the financial accounts of the parent company," *not to compute tax on the basis of a consolidated return.*[42] That is, section 240(d) was not intended to allow the Commissioner to combine and apportion the incomes of related parties as if a consolidated return had been filed.

The provision first assumed substantially its modern appearance when reenacted as section 45 of the Revenue Act of 1928.[43] Section 45 specifically predicated the Commissioner's authority to reallocate income or deductions upon the objective to prevent tax avoidance and ensure the clear reflection of the income of the related parties (to determine their "true tax liability" in the words of the House Ways and Means Report).[44] Neither in the 1928 Act nor in any predecessor legislation was the Commissioner given the authority to combine and apportion the otherwise separate net incomes of related taxpayers.

The proposition that section 482 and its predecessors could not be used by the Internal Revenue Service to combine and apportion the income of two or more related taxpayers or otherwise place them in effect on a consolidated return basis is made abundantly clear by the case law. Construing the scope of section 45 of the 1928 Act in this connection, the Tax Court in *Seminole Flavor Co. v. Commissioner,* 4 T.C. 1215, 1231-32 (1945), rejected the Commissioner's attempt to combine the incomes of a partnership and a corporation owned by the same interests, stating:

> The statute authorizes the Commissioner to "distribute, apportion, or allocate ... between or among such organizations, trade or business," but it does not specifically authorize him "to combine." Certainly, the

[42] H.R. Rep. No. 350, 67th Cong., 1st Sess. 14 (1921) (emphasis added).

[43] ch. 852, § 45, 45 Stat. 806.

[44] H.R. Rep. No. 2, 70th Cong., 1st Sess. 16-17 (1928).

> Commissioner's own regulations, section 19.45-1, Regulations 103, negative the use of section 45 for the purpose of combining or consolidating the separate net incomes of two or more organizations, trades or business, as it states:
>
> > * * * It [sec. 45] is not intended (except in the case of computation of consolidated net income under a consolidated return) to effect in any case such a distribution, apportionment, or allocation of gross income deductions, or any item of either, as would produce a result equivalent to a computation of consolidated net income under section 141.
>
> It is apparent that the Commissioner's action here has produced "a result equivalent to the computation of consolidated income."

As the foregoing makes clear, the suggestion in the California Supreme Court opinion that section 482 contains explicit Congressional authorization to utilize a Unitary Method of taxation which consolidates the income of the combined enterprise is totally erroneous.

In fact, other provisions of the Internal Revenue Code also demonstrate Congress' conscious and consistent adherence to the arm's length method, particularly in the international context. As regards United States taxation of foreign parent-owned foreign corporations, the Code provides for tax jurisdiction in respect of these corporations only on their U.S. source income or income effectively connected with a United States trade or business.[45] While the Code authorizes the filing of consolidated returns, which "combine" the income of a number of separate corporations, foreign corporations generally may not be included in such a consolidated return.[46] In fact, this Court has held as a general rule that except in instances where the corporate form is a "sham or unreal" the separate existence of corporations and their

[45] 26 U.S.C. §§ 881-882.

[46] 26 U.S.C. §§ 1501, 1504(b)(3).

shareholders must be respected.[47] In short, there is no basis for the California Supreme Court's suggestion that section 482 supports or authorizes the use of the Unitary Method or indeed any method other than the arm's length method.

III. THE CALIFORNIA SUPREME COURT'S RELIANCE UPON UNITED STATES TREATIES OF FRIENDSHIP, COMMERCE AND NAVIGATION AS SUPPORTING THE UNITARY METHOD IS INCORRECT.

Another factor relied upon by the California Supreme Court for the proposition that Congress has evidenced its "approval" of California's Unitary Method was Congress' ratification of a number of United States Treaties of Friendship, Commerce and Navigation. The California Supreme Court noted that these treaties, dating from the late 1940's, incorporated provisions that "preserve the states' freedom to employ methods that produced a tax 'reasonably allocable or apportionable' to the taxing jurisdiction...."[48] The California Supreme Court cited in particular an annotated draft of a FCN Treaty with Portugal. It should be clarified that the U.S.-Portugal FCN Treaty has never entered into force. Unlike the draft U.S.-Portugal FCN Treaty, the U.S.-Japan FCN Treaty did enter into force and thus is an appropriate subject of analysis.

If the California Supreme Court, rather than relying on the uneffectuated draft treaty with Portugal, had examined the U.S.-Japan FCN Treaty, coupled with a later FCN Treaty negotiated with France, the court would have been unable to conclude that the U.S.-Japan FCN Treaty supports the Unitary Method. In fact, the U.S.-Japan FCN Treaty requires the states to utilize the arm's length method with respect to the taxation of Japanese corporations.

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47 *Moline Properties, Inc. v. Commissioner*, 319 U.S. 436, 439 (1943).

48 829 P.2d at 297.

FCN Treaties generally provide restrictions on the taxation of corporations resident in the other country.[49] The U.S.-Japan FCN Treaty provides that:

> In the case of companies of either Party engaged in trade or other gainful pursuit within the territories of the other party ... such other Party shall not impose or apply any tax, fee or charge upon any income, capital or other basis in excess of that reasonably allocable or apportionable to its territories, nor grant deductions and exemptions less than those reasonably allocable or apportionable to its territories.[50]

Although the California Supreme Court found that similar language in the draft U.S.-Portugal FCN Treaty was consistent with a finding that Congress approved of the Unitary Method, this interpretation is in error.

The U.S.-Japan FCN Treaty was negotiated in the 1950's prior to the widespread adoption of the Unitary Method, and as this Court has held, a treaty must "be read in light of the conditions and circumstances existing at the time they were entered into...."[51] Because the arm's length method was, and is, the only internationally accepted method, the reasonably allocable or apportionable amount must be determined on the basis of the arm's length method. This conclusion becomes inescapable in view of the effect of the taxation provision in the later ratified U.S.-France FCN treaty.

Article XI(3) of the U.S.-Japan FCN Treaty provides that Japanese corporations shall not be subject to taxes more burdensome than those borne by companies of any *third* country. This "most favored nation" clause in effect restricts subnational

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49 *Sumitomo Shoji Am., Inc. v. Avagliano*, 457 U.S. 176 (1982).

50 U.S.-Japan FCN Treaty, Article XI(4).

51 *Rocca v. Thompson*, 223 U.S. 317, 331-32 (1912).

(*e.g.*, state) taxation of Japanese corporations as a result of the taxation provisions of other international agreements to which the United States is a party, including the Convention of Establishment Between the United States of America and France.[52] Article 9(4) of this Convention provides that:

> [French corporations] shall not be subject, within the territories of the [United States], to any form of taxation upon capital, income, profits or any other basis, except by reason of the property which they possess within those territories, the income and profits derived from sources therein, the business in which they are there engaged, the transactions which they accomplish there, or any other basis of taxation directly related to their activities within those territories.

By reason of the "most favored nation" clause in the U.S.-Japan FCN Treaty, this Article in the Convention with France imposes the obligation to utilize the arm's length method, including at the state level,[53] in determining the tax liability of Japanese corporations. The Article is entirely consistent with the arm's length method as reflected in United States tax treaties and the Internal Revenue Code. It provides for source taxation, taxation of business profits derived from an active trade or business, and transaction based taxation. Failure to require the application of the arm's length method demanded by this provision, when applied to a Japanese company, will violate the U.S.-Japan FCN Treaty.

The California Supreme Court never considered the effect of this later treaty with France, and therefore misinterpreted the "negative implication" of Congress' ratification of FCN Treaties. The existence of FCN Treaties not only fails to support the

[52] 11 U.S.T. 2398, T.I.A.S. No. 4625 (Nov. 25, 1959).

[53] *Hines v. Davidowitz*, 312 U.S. at 64-65 ("This country ... has entered into numerous treaties of amity and commerce since its inception—treaties entered into under express constitutional authority, and binding upon the states as well as the nation.").

California Supreme Court's conclusion; it directly supports the opposite conclusion.

The United Kingdom and the United States are not parties to an FCN Treaty. Therefore, if this Court concludes that the Unitary Method as applied to the Petitioner is constitutional, this Court should reserve on the issue of whether the Unitary Method is nevertheless invalid when applied to a Japanese company protected by the U.S.-Japan FCN Treaty.

CONCLUSION

The California Supreme Court incorrectly upheld the Unitary Method on the basis of "negative implications." It decided Federal Government *silence* is actually Federal Government *speech*. It declared Federal Government *inaction* to be Federal Government *action*. This analysis is wrong and dangerous, and must be rejected. Absent such "negative implications," the application of this Court's "one voice" and multiple taxation tests demonstrates that the Unitary Method violates both of these tests, while the arm's length method does not. If, however, this Court determines that the Unitary Method as applied to U.K.-based Multinational Groups is constitutional, this Court should reserve on the issue of whether the same conclusion may be reached when applied to a

Japan-based Multinational Group entitled to the protections of the U.S.-Japan Tax Treaty and the U.S.-Japan FCN Treaty.

Respectfully submitted.

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(19)

No. 92-1384

In The
Supreme Court of the United States
October Term, 1993

Barclays Bank PLC,
Petitioner,
v.

Franchise Tax Board,
An Agency of the State of California,
Respondent.

On Writ of Certiorari to the Court of Appeal of the State of California in and for the Third Appellate District

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BRIEF OF THE FEDERATION OF GERMAN INDUSTRIES AND THE ASSOCIATION OF GERMAN CHAMBERS OF INDUSTRY AND COMMERCE AS AMICI CURIAE SUPPORTING PETITIONER

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QUESTIONS PRESENTED

1. Whether California's application of worldwide combined reporting to determine the taxable income of domestic corporations with foreign parents, or foreign corporations with either foreign parents or foreign subsidiaries, is unconstitutional under the Foreign Commerce Clause of the United States Constitution.

2. Whether California's application of worldwide combined reporting to determine the taxable income of domestic corporations with foreign parents, or foreign corporations with either foreign parents or foreign subsidiaries, is unconstitutional where such application imposes discriminatory compliance burdens on such entities.

3. Whether California's application of worldwide combined reporting to determine the taxable income of domestic corporations with foreign parents, or foreign corporations with either foreign parents or foreign subsidiaries, intrudes into an inherently federal area and is preempted by the United States Constitution.

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AN AGENCY OF THE STATE OF CALIFORNIA,
Respondent.

On Writ of Certiorari to the Court of Appeal of the State of California in and for the Third Appellate District

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BRIEF OF THE FEDERATION OF GERMAN INDUSTRIES AND THE ASSOCIATION OF GERMAN CHAMBERS OF INDUSTRY AND COMMERCE AS AMICI CURIAE SUPPORTING PETITIONER

INTEREST OF AMICI CURIAE

The Federation of German Industries (Bundesverband der Deutschen Industrie) (herein "BDI") is composed of 34 member organizations, for example, the Confederation of Chemical Industry, and represents virtually all the manufacturing enterprises' associations in Germany. The Association of German Chambers of Industry and Commerce (Deutscher Industrie- and Handelstag) (herein "DIHT") is made up of 85 local Chambers of Industry and Commerce, which represent about 2,800,000 indus-

trial and trade enterprises. Since membership in DIHT is mandatory, virtually all German companies are included.

The purpose of BDI and DIHT is to represent German businesses and their interests on a national and international level. Practically all major German industrial companies having well-recognized trade names in the United States, such as Bayer, BASF, Volkswagen, BMW, Mercedes-Benz, and Siemens, for example, belong to BDI and DIHT. Thus, both are concerned by, and opposed to, Respondent's reliance upon the method of corporate income allocation known as worldwide combined reporting ("WWCR").

The Council submits this brief *amici curiae* in support of Petitioner.[1]

SUMMARY OF ARGUMENT

No country uses WWCR. The foreign policy of the United States in taxation of international corporate income is in agreement with international principles of corporate taxation: WWCR is not accepted. That policy is embodied in United States treaty and statutory provisions, as well as clearly and consistently expressed by the Federal Government.[2]

The use of WWCR to include overseas income and factors in California's taxation of domestic corporations with foreign parents, or foreign corporations with either foreign parents or foreign subsidiaries, clearly prevents the United States from speaking with one voice in matters of

[1] Petitioner and Respondent have consented to the filing of this brief *amici curiae* in letters filed with the Clerk of this Court.

[2] See, for example: The Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and Capital and to Certain Other Taxes, with a related Protocol, exchange of notes and memorandum of understanding. Signed at Bonn, August 29, 1989; Brief For the United States as Amicus Curiae submitted herein, p. 3, n.2; and Pet. App. H10 for a complete list of U.S. income tax treaties.

foreign commerce: foreign policy issues which must be left to the Federal Government are implicated, thereby violating the Foreign Commerce Clause of the United States Constitution.[3]

ARGUMENT

I. THE APPLICATION OF WORLDWIDE COMBINED REPORTING TO FOREIGN CORPORATIONS AND DOMESTIC SUBSIDIARIES OF FOREIGN CORPORATIONS IS AT VARIANCE WITH THE UNITED STATES FEDERAL GOVERNMENT'S POLICY OF INTERNATIONAL CORPORATE TAXATION.

The United States Federal Government's international tax policy is embodied in the Internal Revenue Code provisions for the income taxation of foreign corporations and in all the double taxation treaties of which the U.S. is a signatory.[4] This policy provides a coherent allocation system for eliminating double taxation of multinational corporate groups. These statutory and treaty provisions embody the "voice" of the Federal Government in the vital area of international commercial relations. This voice establishes separate accounting among affiliated corporations based upon the arm's length principle as the coherent federal policy under which income is allocated between the U.S. and foreign countries.

The arm's length principle is based upon the economic concept of market pricing, the foundation of the free world economic system. It says, in effect, that if one business within an international corporate group sells to another within the same group, but operates within a different taxing jurisdiction, the profits attributable to the taxing jurisdictions shall be the profits expected to be made in those jurisdictions if they were separate and independent businesses engaged in the same or similar activities under

[3] U.S. Const., art. 1, § 8, cl. 3.

[4] At present there are forty such treaties ratified and in effect. The express purpose of these treaties is the avoidance of international double taxation.

the same or similar conditions and dealing wholly independently with each other.

Respondents rejects international corporate taxation principles when it uses WWCR. Separate entities—foreign and domestic—making up a multinational corporate group are treated as one. Their combined income is apportioned between California and the rest of the world on the basis of an arbitrary formula of the ratio of payroll, sales, and property of the entire corporate group in California compared to the world. No regard is given to whether such income is taxable under the Internal Revenue Code or applicable treaty, nor to the fact that income has been attributed to and taxed in foreign jurisdictions in accordance with international law.

II. THE APPLICATION OF WORLDWIDE COMBINED REPORTING TO FOREIGN CORPORATIONS AND DOMESTIC SUBSIDIARIES OF FOREIGN CORPORATIONS PREVENTS THE UNITED STATES FROM SPEAKING WITH ONE VOICE WHEN REGULATING COMMERCIAL RELATIONS WITH FOREIGN GOVERNMENTS.

This Court has set forth straightforward tests for judging the constitutionality of a state tax. In *Japan Line, Ltd. v. County of Los Angles,* two additional tests, other than those used in assessing constitutionality under the interstate commerce clause, were described, the contravention of either of which would render a state tax unconstitutional:

> first, whether the tax creates a substantial risk of international multiple taxation; and second, whether the tax prevents the Federal Government from speaking with one voice when regulating commercial relations with foreign governments.[5]

In *Container Corp. of America v. Franchise Tax Board,* this Court explained that a state tax:

[5] 441 U.S. at 451 (1979).

> at variance with federal policy will violate the "one voice" standard if it *either* implicates foreign policy issues which must be left to the Federal Government *or* violates a clear federal directive . . .;

and specified that:

> The most obvious foreign policy implication of a state tax is the threat it might pose of offending our foreign trading partners and leading them to retaliate against the nation as a whole.[6]

The use of WWCR clearly meets those tests. The twelve Member States of the European Communities: Belgium, Denmark, France, Germany, Greece, Ireland, Italy, Luxembourg, The Netherlands, Portugal, Spain, and the United Kingdom; and the Governments of Australia, Austria, Canada, Finland, Japan, Norway, Sweden and Switzerland have repeatedly expressed their formal objections to Respondent's use of WWCR as:

> (1) contradictory to, and incompatible with, accepted international principles of corporate tax assessment and the purpose of double taxation and/or friendship, commerce and navigation treaties to which the United States is a party;
>
> (2) an impediment to investment and trade with the U.S.[7]

Even retaliation, the "most obvious foreign policy implication of a state tax,"[8] has materialized. Section 54 of and Schedule 13 to the Finance Act of 1985 (now reenacted as Section 812-815 of the Income and Corporations Taxes Act 1988) gives the United Kingdom power to retaliate for the use of WWCR by withdrawing from

[6] 463 U.S. at 194 (1983).

[7] See Brief of the Member States of the European Communities and the Governments of Australia, Austria, Canada, Finland, Japan, Norway, Sweden and Switzerland as Amici Curiae Supporting Petitioner, (April 22, 1993).

[8] 463 U.S. at 194.

American corporations incorporated in California or having their principal place of business there, the right to claim shareholders' tax credit in respect of dividends paid to them by their United Kingdom subsidiaries.

III. THE APPLICATION OF WORLDWIDE COMBINED REPORTING TO FOREIGN CORPORATIONS AND DOMESTIC SUBSIDIARIES OF FOREIGN CORPORATIONS IS DIFFERENT FROM ITS APPLICATION TO DOMESTIC PARENT CORPORATIONS WITH FOREIGN SUBSIDIARIES.

The use of WWCR to include the worldwide income of foreign corporations doing business in the United States and of their domestic subsidiaries is fundamentally different from the situation involving domestic parent corporations with foreign subsidiaries. The United States Federal Government taxes the income of domestic multinational corporate groups, subject to the provisions of the Internal Revenue Code, including tax credits, tax deferrals, and various other sections designed to alleviate double taxation. This broad jurisdiction does not exist with regard to foreign corporations or foreign parent corporations with domestic subsidiaries. The only income from their operations subject to the U.S. taxing jurisdiction is income with a geographical source in the U.S., i.e., the U.S. portion of a foriegn corporation's income, or the income of its domestic subsidiary. As seen above, the U.S. approach of exercising its tax jurisdiction on a residence or source of income basis is generally consistent with international practice.

When WWCR is applied to U.S. parent corporations with foreign subsidiaries, income attributable to those foreign subsidiaries is included in calculating the taxable income of the domestic corporation. The legal incidence of the tax falls on a domestic corporation. However, as in this case, when WWCR is applied to a foreign corporation, with U.S. income and a U.S. subsidiary, a foreign corporation's income is directly impacted. It is that income, and the income of the foreign corporation's foreign subsidiaries, earned and taxed by foreign governments under separate accounting principles, that California is also taxing.

The discriminatory effect of the burden to comply with the reporting requirements of WWCR is also more obvious in the case of a foreign parent corporation. WWCR requires corporate taxpayers to provide details of taxable income for worldwide operations translated into English and adjusted to U.S. and even specific state taxation accounting principles and U.S. currency. An American parent corporation is at least familiar with the United States and States' taxing accounting concepts and unitary principles, however costly it may be to comply. A foreign parent is not familiar with those concepts and principles, making compliance much more burdensome. Foreign parent corporations in a number of countries already have to provide details of taxable income of worldwide operations translated and adjusted to the accounting principles and currency of their country of residence. If they also have to provide similar information about the group as a whole in all countries in which a member of the group operates, that puts a disproportionate burden on international business.

The relationships between domestic and foreign-based corporate groups and their subsidiaries are also distinct. WWCR requires the income and activities of a foreign parent corporate group to be taken into account solely on the basis of activities which it attributes to the United States, when most often neither the foreign parent nor other subsidiaries conduct any business in the U.S. While it may be argued that domestic parent corporations exercise control over their foreign subsidiaries, thereby making the income and activities of the domestic parent group susceptible to attribution to the U.S., it is plain that domestic subsidiaries of foreign parent corporations do not control their foreign parents. Thus, the attribution by

WWCR of foreign income of foriegn parents and their foreign subsidiaries is clearly inappropriate.

CONCLUSION

Respondents' use of WWCR is patently inconsistent with United States policy. It prevents the United States Federal Government from speaking with one voice in a field that must be left to it. The implication of United States foreign policy by WWCR is a matter of international record. Its application to foreign corporations and foreign corporations with U.S. subsidiaries is clearly unconstitutional: an obvious violation of the Foreign Commerce Clause of the United States Constitution.

The Federation of German Industries and The Association of German Chambers of Industry and Commerce respectfully ask this Court to reverse the decision of the California Supreme Court.

Respectfully submitted,

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Dated December 15, 1993.

No. 92-1384

IN THE
Supreme Court of the United States
OCTOBER TERM, 1993

BARCLAYS BANK PLC,
Petitioner,
v.

FRANCHISE TAX BOARD,
AN AGENCY OF THE STATE OF CALIFORNIA,
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On Writ of Certiorari to the Court of Appeal of the State of California in and for the Third Appellate District

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BRIEF OF THE COUNCIL OF NETHERLANDS INDUSTRIAL FEDERATIONS AS AMICUS CURIAE SUPPORTING PETITIONER

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QUESTIONS PRESENTED

1. Whether California's application of worldwide combined reporting to determine the taxable income of domestic corporations with foreign parents, or foreign corporations with either foreign parents or foreign subsidiaries, is unconstitutional under the Foreign Commerce Clause of the United States Constitution.

2. Whether California's application of worldwide combined reporting to determine the taxable income of domestic corporations with foreign parents, or foreign corporations with either foreign parents or foreign subsidiaries, is unconstitutional where such application imposes discriminatory compliance burdens on such entities.

3. Whether California's application of worldwide combined reporting to determine the taxable income of domestic corporations with foreign parents, or foreign corporations with either foreign parents or foreign subsidiaries, intrudes into an inherently federal area and is preempted by the United States Constitution.

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INTEREST OF AMICUS CURIAE

The Council of Netherlands Industrial Federations (Raad van Nederlandse Werkgeversverbonden) (herein "The Council") consists of the Federation of the Netherlands Industry (Verbond van Nederlandse Ondernemingen) and the Netherlands Christian Federation of Employers (Nederlands Christelijk Werkgeversverbond). Both organizations are federations together consisting of 150 trade and employers' associations, representing more than 50,000 enterprises with over 2,000,000 employees, which is two-thirds of the private sector employment in the

Netherlands. Over 400 companies, including a number of public utilities, are also members. In addition, more than 6,000 individual employers and entrepreneurs are personal members. The combined membership, which includes all large and most medium-sized companies in the Netherlands, spans virtually all sections of its economy: manufacturing, building and construction, land, sea and air transport, harbors, banking, insurance, wholesale trade, department and chain stores, publishing and fisheries.

A strong international orientation has long been a characteristic of the Dutch economy. This is reflected in the interests of the federations' members, a number of which have subsidiaries in, or do business in, the United States. The Council is firmly committed to healthy international relations that foster international trade and investment. Likewise, it strongly objects to measures that cause international double taxation or otherwise impede the free development of the world economy.

Like the Dutch Government, the Council has always actively opposed the application of the method of corporate income allocation known as worldwide combined reporting ("WWCR"). As early as 1980, the Council appeared before hearings held by the Committee on Ways and Means of the United States House of Representatives to express its opposition to WWCR as a cause of international double taxation and to explain the more onerous administrative burden that WWCR imposes on foreign based multinational corporations than on such corporate groups based in the United States.[1]

The Council submits this brief *amicus curiae* in support of Petitioner.[2]

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[1] *Hearings on H.R. 5076 before the House Committee on Ways and Means*, 96th Cong., 2d Sess. (1980), (statement of Joseph H. Guttentag, Counsel, on behalf of the Dutch Employers' Federation).

[2] Petitioner and Respondent have consented to the filing of this brief *amicus curiae* in letters filed with the Clerk of this Court.

ARGUMENT

I. WORLDWIDE COMBINED REPORTING IS INCOMPATIBLE WITH THE INTERNATIONALLY ACCEPTED ARM'S LENGTH SEPARATE ACCOUNTING ("AL/SA") PRINCIPLE AND THEREFORE CAUSES DOUBLE TAXATION.

Over a long period of time the governments of the major economic countries have developed, and then preserved, AL/SA as an effective means of ensuring that corporate income will be taxed only where it arises in an economic sense. Thus, a major impediment of the development of international trade and investment—the double taxation of the income of internationally active multinational corporate groups—can be effectively combatted. The United States Federal Government has played a leading role in the development of AL/SA and has unreservedly endorsed the enshrining of the principle in, for example, the OECD Model Taxation Convention and the official Commentary thereon.[3]

WWCR, as applied by Respondent Franchise Tax Board of California, is incompatible with the internationally accepted and internationally applied AL/SA. WWCR conflicts with the United States' use of AL/SA in all its double taxation treaties and causes double taxation.

Inherent in Respondent's application of WWCR is the deliberate refusal to accord significance to the presence or absence of any economic connection between the income it seeks to tax and the State of California. It is assumed that three arbitrary factors, property, payroll, and sales, provide a justifiable basis for determining by pro rata allocation the taxable income to be subject to the various

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[3] Report of the OECD Comm. on Fiscal Affairs, Model Double Taxation Convention on Income and on Capital, arts. 5(7), 7(2), 9(1) (1977).

taxing jurisdictions with which such income is economically connected. That assumption ignores the economic diversity of the activities giving rise to the income and disregards the differing economic climates in which the income was earned. Unless the application or WWRC is limited to a reasonable homogenous economy, such as found in the United States, the assumption is necessarily false and conflicts with the application by other taxing authorities of the more objective and realistic AL/SA. Double taxation of the same income in a significant number of cases is unavoidable with WWCR, thus seriously impeding international trade and investment.

II. THE APPLICATION OF WORLDWIDE COMBINED REPORTING BY A STATE CAUSES THE UNITED STATES TO DEFAULT ON ITS INTERNATIONAL OBLIGATIONS.

On August 18, 1983 Minister of Finance for the Netherlands H. O. Ruding wrote to United States Secretary of the Treasury Donald T. Regan:

> For the Netherlands Government the issue of unitary taxation has been of great concern for a considerable period of time as you may be aware. During the negotiations on the revision of the double taxation convention between our countries it has repeatedly been stressed that it is an anomaly to discuss the matter of avoidance of double taxation when—as a result of the unitary method—double taxation remains an inevitable consequence of operating a business within the territory of the convention.

The decision of the California Supreme Court would deny the precedence of the United States Federal Government's international tax policy over California's tax policy. Without such precedence, the United States cannot deliver on its international commitments to prevent taxation of income not reasonably allocable to its jurisdiction and to ensure fair and reasonable treatment of its treaty partners' corporations. These commitments arise

from all the treaties for the avoidance of double taxation and from the many treaties of friendship, commerce, and navigation ("FCN") to which the United States is a party. The Council notes that the Netherlands and the United States have both a double taxation treaty and a FCN treaty in force.[4]

If the United States Federal Government cannot effectuate its treaty obligations, its ability to negotiate such treaties will be seriously impaired. This impairment cannot but jeopardize the chances of the United States and its potential treaty partners to achieve optimum progress toward their common goal—the removal, or at least mitigation, of the many impediments to international trade and investment.

III. THE APPLICATION OF WORLDWIDE COMBINED REPORTING LEADS TO UNACCEPTABLE COMPLIANCE BURDENS ON FOREIGN BASED MULTINATIONAL CORPORATE GROUPS.

With all its double taxation treaties the United States protects corporations of its treaty partners and their subsidiaries against more burdensome taxes and compliance difficulties than affect their American counterparts. The United States also affords fair and reasonable treatment under its FCN treaties. For example, a foreign based multinational corporation will not ordinarily have to restate its accounts in accordance with the accounting principles of the United States or one of its states, nor need to translate its accounts into U.S. dollars or all its records

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[4] The Convention between the United States of America and the Kingdom of the Netherlands with Respect to Taxes on Income and Certain Other Taxes, signed at Washington, April 29, 1948, 6 U.S.T. 3696, T.I.A.S. No. 1855, as amended by the Supplementary Convention, signed at Washington, December 30, 1965, 17 U.S.T. 896, T.I.A.S. No. 6051; The Treaty of Friendship, Commerce and Navigation between the United States of America and the Kingdom of the Netherlands, signed at the Hague, March 27, 1956, 8 U.S.T. 2043, T.I.A.S. No. 1855.

in English. WWCR requires such restatement and translation, thereby putting a disproportionate compliance burden on foreign based multinational corporate groups. The decision of the California Supreme Court below would allow discrimination against foreign corporations and the conflict with the commitments of the United States towards fairness to persist.

IV. RECENT CALIFORNIA LEGISLATION DOES NOT PREVENT THE REINTRODUCTION OF WORLD-WIDE COMBINED REPORTING.

It cannot be argued that recent California legislation has reduced the need for this Court to establish the unconstitutionality of WWCR. If the decision of the California Supreme Court below is upheld, nothing will prevent California, or any other state, from introducing (again) WWCR whenever they judge it to be in their best interest. This threat is in itself an impediment to international trade and investment. Unless this Court reverses the decision of the California Supreme Court the exposure of foreign based multinational corporations to treatment conflicting with the international commitments of the United States will continue.

CONCLUSION

For these reasons, the Council of Netherlands Industrial Federations respectfully asks this Court to reverse the decision of the California Supreme Court, thereby upholding the decision of the Court of Appeal of the State of California in and for the Third Appellate District as to the unconstitutionality of Respondent's use of WWCR under the Foreign Commerce Clause of the United States Constitution, Article 1, Section 8, Clause 3.

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Dated December 15, 1993.

(2)

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BRIEF OF ORGANIZATION FOR INTERNATIONAL INVESTMENT INC. AND UNION OF INDUSTRIAL AND EMPLOYERS' CONFEDERATIONS OF EUROPE AS *AMICI CURIÆ* IN SUPPORT OF PETITIONER

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INTEREST OF *AMICI CURIÆ*

The Organization for International Investment Inc. ("OFII") is a non-profit corporation the members of which are United States subsidiaries of foreign shareholders.[1] The Union of Industrial and Employer's Confederations of Europe ("UNICE") is recognized as the official representative of European business and industry vis-a-vis the European Union's institutions.[2]

1. Appendix 1 lists OFII members. Neither the petitioner nor any of its subsidiaries and affiliates are members of OFII.
2. Appendix 2 lists UNICE member organizations.

OFII members are domestic corporations operating principally within the United States in manufacturing, wholesale and retail distribution, and performance of services. OFII members export manufactured and processed goods as well as import manufactured articles and raw materials. OFII represents members' interests in matters of federal and State taxation and seeks legislative and judicial solutions to problems affecting economic interests of members. OFII members have a direct interest in the international aspects of the tax issues presented by this case. Similarly to the petitioner, OFII members are treated as unitary with their foreign affiliates and bear an increased and discriminatory tax burden under California law. OFII members are assessed California taxes on foreign income of their foreign parents and other affiliated companies that do no business in California or in the United States. The California method of worldwide unitary combination for taxation creates a substantial impediment to commerce with and investment in the United States by foreign persons including foreign parents and affiliates of OFII members.

The member federations of UNICE are the official representatives of all sectors of business and industry in their respective nations. UNICE comprises thirty-two member federations from twenty-four European nations including all European Union and European Free Trade Association nations. UNICE's permanent secretariat is in Brussels, Belgium. An important objective of UNICE is to promote international commerce and investment by eliminating international double taxation. California's taxation of foreign source income of foreign companies that is excluded from federal taxation is a direct impediment to the free flow of trade and investment between the United States and the nations represented by UNICE's member federations. Such taxation is in contravention of the foreign commerce policy of the United States and its taxation treaties with other nations. UNICE is particularly concerned with the chilling effect the extraterritorial reach of California's worldwide unitary combination for taxation has on foreign direct investment in the United States by UNICE's member components.

SUMMARY STATEMENT

In upholding California's authority to tax income earned by corporations outside the jurisdiction of the United States by apportioning their worldwide income to their U.S. affiliates in contravention of federal and international law and practice adopted by the OECD nations, the California Supreme Court disregarded longstanding precedents of the United States Supreme Court.[3] The decision below effectively declares that only an express Act of Congress can prohibit a State from utilizing any method it chooses to tax international commerce. This decision ignores constraints on State taxation of foreign commerce established by this Court more than twenty years ago. It is irrefutable that "the analysis and holdings of the California Supreme Court are subject to serious question."[4]

California's method of taxing U.S. companies with foreign ownership effectively subjects the non-U.S. profits of those foreign parents and their non-U.S. affiliates to California tax. This has provoked consistent and vigorous protests from the governments and businesses of trading partners of the United States. California's worldwide method also has been consistently opposed by the federal Executive as an intrusion into federal prerogatives in foreign affairs and commerce. California's recent legislation[5] is emphatically *not* a reason to allow the irresponsible decision of the California Supreme Court to stand as precedent. That legislation has no effect on taxes unconstitutionally collected long before the legislation was enacted. The constitutional limit of State power to tax international commerce is as much an issue as ever. California has neither conformed to the federal and international standard nor renounced the *claim of right* to reimpose mandatory unitary taxes

3. E.g. *Japan Line, Ltd. v County of Los Angeles*, 441 U.S. 434 (1979). This Court's concern over foreign reaction to aberrant State actions was expressed as early *Chy Lung v Freeman*, 92 U.S. 275 (1875).

4. Solicitor General's brief *amicus curiæ* for the United States, opposing the grant of *certiorari*, p. 8.

5. SB 671, signed into law on 6 October 1993. Relevant portions of this Act are reproduced as appendix A to the Supplemental Brief of Respondent in Opposition.

on foreign commerce at the whim of its legislature.

State taxation of domestic parent corporations with foreign subsidiaries necessarily rests on a different footing than State taxation of foreign parent corporations with U.S. subsidiaries. To the extent California's tax practices contravene U.S. international tax policy and burden international investment, they invite foreign countermeasures *against businesses in the United States as a whole.* This is what makes California's tax method unconstitutional.

There can be no question of regarding worldwide unitary taxation as an alternative to arm's length separate accounting. The United States and all of its major trading partners observe and implement the arm's length method by treaty and by statute. If that method is to be abandoned, it can only be done by international agreement. As a State of the United States, California is not permitted to enter into or negotiate international agreements but, under the "one voice" principle, must conform to federal practice in international matters.

ARGUMENT

I. THE CALIFORNIA SUPREME COURT'S DECISION IN BARCLAYS BANK IGNORES GUIDELINES FOR TAXATION OF INTERNATIONAL COMMERCE ESTABLISHED BY THE UNITED STATES SUPREME COURT.

The California District Court of Appeal initially decided that the petitioner, Barclays Bank PLC ("Barclays"), was entitled to a refund because application of California's worldwide, combined unitary apportionment method of taxing[6] foreign parent companies' incomes violated the Commerce Clause of the United States Constitution.[7] The California Supreme Court reversed this in an

6. This method will hereafter be referred to as "unitary taxation" or the "unitary tax."

7. See Appendix B to the Petition for a Writ of *Certiorari* in this case for the full text of the initial opinion.

opinion that inverts the United States Supreme Court's Commerce Clause jurisprudence.[8]

Constitutional limits on the power of a State to tax multinational corporations were established in a series of cases beginning with *Japan Line, Ltd. v County of Los Angeles.*[9] That case holds that a State tax on an instrumentality of commerce owned by a *foreign* person is prohibited by the Commerce Clause if it interferes with the ability of the United States to "speak with one voice" in foreign affairs or presents a risk of double taxation. *Container Corp. of America v Franchise Tax Bd.*[10] reaffirmed the *Japan Line* principles while permitting the State to tax *domestic* corporations with foreign subsidiaries on a unitary basis. *Container* explicitly recognized the distinction between taxing a U.S. parent company on its foreign subsidiary's income and taxing a U.S. subsidiary on its foreign parent's income. Your *amici* take no position on the constitutional merits of the companion case of *Colgate Palmolive Co. v Franchise Tax Bd.*, involving a domestic parent company.

This Court reaffirmed the general principles of *Japan Line* and *Container* last term in *Kraft General Foods v Iowa Dep't of Rev. & Finance.*[11] That case dealt with discriminatory treatment of foreign dividends rather than discriminatory treatment of foreign investments. But this language from *Kraft* is equally applicable to the case at bar:

> In *Japan Line, Ltd. v County of Los Angeles* ..., we concluded that the constitutional prohibition against state taxation of foreign commerce is broader than the protection afforded to interstate commerce, ... in part because matters of concern to the entire Nation are implicated .... Like the Import-Export Clause, ... the Foreign Commerce Clause recognizes that discriminatory treatment of foreign comThe

8. Text of this opinion is found in Appendix C to the Petition for a Writ of *Certiorari.*

9. 441 U.S. 434 (1979).

10. 463 U.S. 159 (1983).

11. 505 U.S. ___, 112 S.Ct. 2365 (1992).

> merce may create problems, such as the potential for international retaliation, that concern the Nation as a whole.
> [112 S.Ct. at p. 2370, citations omitted]

The California Supreme Court have discarded these principles based on a distorted reading of the decision of this Court in *Wardair Canada v Florida Dep't of Revenue.*[12] But there is nothing in the *Wardair* opinion suggesting that this Court have abandoned dormant commerce clause analysis or that the principles of *Japan Line* and *Container,* as reaffirmed in *Kraft,* no longer apply. *Wardair* involved a State sales tax levied under an express *federal* statutory exception. The issue was whether that exception had been abrogated by an international convention that this Court found to be inapplicable. The doctrine the California Supreme Court erroneously distill from *Wardair* is that a State may impose any tax it chooses upon foreign commerce until specifically forbidden by Congress. Were this truly the case, then *Japan Line* would be in error; *Container* would have been an exercise in futility; and *Kraft* would have missed the point.

Members of the international business community represented by *amici* believe that the opinion of the California Supreme Court in the instant case conflicts with the decisions of this Court and that the opinion poses a substantial impediment to foreign investment in the United States. Should a significant number of other States choose to follow the California Supreme Court's decision, havoc would be wrought on the international trade of the United States.[13]

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12. 477 U.S. 1 (1986).

13. Several States permit some form of worldwide unitary taxation that does not directly involve income of non-resident foreign companies. North Dakota's statute is virtually identical to California's, but the State has little foreign investment. Alaska applies unitary only to oil and gas production and transportation; Arizona and Indiana exclude foreign entities not conducting business within the State; New York and Tennessee require worldwide combination only if the arm's length method fails to reflect income properly; Montana exempts foreign parent affiliated groups; New Hampshire applies the method only to dividends from foreign affiliates.

II. RECENT CALIFORNIA LEGISLATION DOES NOT ADDRESS THE BARCLAYS BANK ISSUE AND DOES NOT REMEDY THE UNDERLYING PROBLEMS WITH WORLDWIDE UNITARY COMBINATION.

California has recently modified its worldwide unitary tax system as a result of extreme pressure from the Administration and the threat of counter action by foreign governments against U.S. corporations doing business abroad.[14] The United Kingdom's threat of retaliation against U.S. companies probably had the greatest impact[15]. Although the California legislation has deferred implementation of retaliatory measures by the U.K., it clearly has not fully satisfied the concerns of foreign governments.[16] The reasons for this are quite apparent: (1) The legislation takes effect prospectively from 1994 and does not address the previous twenty years of taxes wrongly collected; and (2) California has not renounced its claim of right to impose worldwide unitary taxation on foreign parent corporations. The legislation retains worldwide unitary as the norm, and only conditionally permits corporations to "elect" exclusion of *most*[17] foreign source in come of affiliated foreign corporations (generally referred to as a "water's edge election").

This is not the appropriate case to analyze the specific provisions of SB 671. By its own terms, it has no effect on the amounts or the years at issue before this Court. It was a pragmatic response to a sense of international outrage that did not do away with the need for this Court to deal with the important legal issues

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14. SB 671, *supra,* n. 5.

15. See Appendix 3; *cf.* Appendix 6.

16. See Appendices 3, 4, and 5.

17. There are serious unresolved issues in the new law of what actually constitutes "water's edge" income of a domestic taxpayer. Formulary apportionment still applies to those foreign entities whose U.S. apportionment factors equal or exceed 20% of the total. SB 671 Section 22, amending Cal. Rev. & Tax Code § 25110(a)(3). It is also unclear to what extent U.S. source income of an affiliated foreign entity may be attributed to a California taxpayer under the State Board of Equalization's nexus rules.

at stake in the instant case. The only significant point is that according to the decision of the California Supreme Court, the California Legislature may reinstate mandatory, worldwide, unitary taxation at any time, without constitutional restraint. It has taken more than ten years for this case to reach this Court; were California free to reinstate mandatory worldwide unitary combination after this case is decided, international outrage would be inevitable, the integrity and authority of the United States as one nation thrown into doubt, and U.S. trade and investments abroad exposed to the very real risk of damaging counter-measures.

Your *amici* vigorously disagree with the statement of the Solicitor General in the *amicus* brief for the United States opposing *certiorari* (p. 10) that "[f]urther review by this Court is not needed to achieve, and could potentially destabilize, the accommodation of state, national and international interests that has been reached on this issue." No such accommodation has been reached on this issue, at least internationally, as shown by the official statements of foreign governments.[18] These statements only underscore the need for this Court to provide firm guidelines on the extent to which federal and international tax policy supervenes State tax considerations in matters affecting foreign commerce. The international business community prays this Court not to allow the voice of the United States heard abroad to be reduced to a babble of diverse and conflicting State policies.

III. STATE TAXATION OF FOREIGN PARENT COMPANIES RESTS ON A DIFFERENT FOOTING THAN STATE TAXATION OF DOMESTIC PARENT COMPANIES. STATE TAXATION OF FOREIGN SOURCE INCOME OF FOREIGN PARENT COMPANIES IS CLEARLY UNCONSTITUTIONAL.

18. Statement of Rt. Hon. Kenneth Clarke, Chancellor of the Exchequer, Sep. 15, 1993, Appendix 3; Demarche of the European Community, Sep. 24, 1993, Appendix 4; and Demarche of the 20 countries, Oct. 14, 1993, Appendix 5.

Your *amici*, organizations that fairly represent the spectrum of major foreign investors in the United States, are very concerned with both double taxation and discriminatory treatment of those investments by application of California's unitary tax method. California presumes[19] that in-State activities benefit all commonly owned businesses elsewhere irrespective of the forms of organization or lack of economic nexus amongst those businesses. Whatever validity this presumption may have in the context of a domestic parent company, which is the ultimate recipient of group earnings, it has none with respect to a parent company located in a foreign nation. The price of investment in California should not include foreign investor compliance with California record-keeping and tax accounting principles for income from sources having no connection with California. It is this intrusion into business affairs of foreign persons that has led to so much international protest. No trading partner of the U.S. seeks to impose a comparable requirement on U.S. companies investing abroad.[20]

California's inclusion of foreign parent income in the tax base creates an "enhanced risk of multiple taxation."[21] The principal reason for this risk is the "absence of an authoritative tribunal capable of ensuring that the aggregation of taxes is computed on no more than one full value ...."[22] A foreign parent whose income is attributed to its U.S. subsidiary does not even have standing in

19. "A taxpayer is engaged in a unitary business ... when its activities within the state contribute to or are dependent upon its activities without the state." 18 Cal. Admin. Regs. § 25137-6(a)(1).

20. The elements of "unitary" in California jurisprudence are elusive. Cf. *Tenneco West, Inc. v Franchise Tax Bd.*, 91 C.D.O.S. 8183 (Cal. App. 4th Dist. 1991) with *Mole Richardson Co. v Franchise Tax Bd.*, 220 Cal. App. 3d 889, 269 Cal. Rptr. 662 (1990). The respondent Franchise Tax Board attempted for some years to develop "diverse business regulations" to define what is unitary and what is not. That attempt has been altogether adandoned. A case by case approach continues to be used. More recently, the Franchise Tax Board has taken the position that share ownership alone should be sufficient. This is similar to the grounds unsuccessfully argued by *New Jersy in Allied-Signal, Inc. v Director, Div. of Taxation* ___ U.S. ___, 112 S.Ct. 2251 (1992).

21. *Container Corp. v Franchise Tax Bd.*, 463 U.S. at p. 185; *Japan Line v County of Los Angeles*, 441 U.S. at pp. 447-48.

22. *Japan Line*, 441 U.S. at pp. 447-448; quoted in *Container* at 463 U.S. pp. 185-86.

U.S. courts to challenge the income attribution.[23] The petitioner in the instant case was only able to achieve standing by virtue of itself doing business in California. Most foreign parent companies are denied even that remedy. It is the *potential* as well as the actuality of double taxation and burdensome compliance costs that create an unreasonable risk for the foreign parent company.[24]

Even more distressing is California's refusal to recognize the primary right of the foreign parent's nation of domicile to tax income sourced in that domicile. California provides no foreign tax credit on previously taxed foreign income. The respondent, indeed, declares unequivocally that income from foreign sources apportioned to California by the unitary tax formula *is really California source income.*[25] California thereby constrains foreign jurisdictions to adopt similar taxing methods in order to protect their own nationals from double taxation of income that, under accepted international practice, is sourced outside of California.

This Court recognized the distinction between State taxation of international commerce involving a domestic parent and taxa

23. *Franchise Tax Bd. v Alcan Aluminium, Ltd.*, 493 U.S. 331 (1990). While the foreign parent's and its non-U.S. subsidiaries' income may be *taxed* in California to the domestic subsidiary, California does not deem the foreign parent to be a *taxpayer*, hence has no standing to seek redress in California courts. Cal. Rev. & Tax Code § 23037 and § 23102. *Cf. EMI Ltd. v Bennett*, 738 F.2d 994 (9th Cir.), *cert. denied* 469 U.S. 1073 (1984).

24. The respondent's regulations for "Combined Reports Including Foreign Country Operations," Cal. Admin. Code § 25137-6, are so complex as to be virtually unadministrable. See testimony of respondent's own witness, Professor Shank, TR. pp. 1984 — 2038, especially pp. 2014—2017. In lieu of data and records normally not maintained by foreign companies, the Franchise Tax Board is empowered to accept "reasonable approximations." The respondent, however, is the sole arbiter of "reasonable."

25. A paper was presented in May, 1991, to the Third Annual Washington D.C. Liaison between government tax representatives and the State Bar of California, entitled "Problems with Federal Sourcing of State Franchise Taxes under the 861 Regulations" by Eric J. Cofill, Senior Tax Counsel to the respondent. 1 *California Tax Lawyer* No. 3, pp. 24-26 (Fall 1991). This paper complains of the federal government's insistence that California taxes on income apportioned from foreign sources are taxes on foreign source, not California source income. The paper suggested this was because "[t]he Administration's opposition to the states' use of the unitary method is well known, and may also account for the position taken in the the regulations."

tion of a foreign parent.[26] While there may be valid reasons for revisiting the *Container* decision,[27] it is not necessary to disturb that opinion in order to reach an appropriate result in the instant case. This Court is urged to adopt the position heretofore taken by the United States Government in numerous briefs filed before the California courts in this case that unitary taxation of foreign parent companies is clearly unconstitutional.

IV. THE MERITS OF UNITARY TAXATION VERSUS SEPARATE ACCOUNTING HAVE NO BEARING ON THE ISSUES IN THIS CASE. SEPARATE ACCOUNTING HAS BEEN THE ESTABLISHED FEDERAL AND INTERNATIONAL STANDARD FOR OVER FORTY YEARS.

The Multistate Tax Commission filed an extensive *amicus* brief with the California Supreme Court in 1991 arguing that the separate accounting system of international taxation, generally referred to as the "arm's length method," utilized by the federal government and its foreign trading partners, is greatly inferior to the unitary method. It is anticipated that a similar argument will be made by the Commission in a brief to be filed with this Court supporting the respondent.

The Commission were established by the Multistate Tax Compact to assist participating States employing the unitary method to tax interstate transactions.[28] The Commission provide audit assistance and proposes model regulations and model statutes for this purpose. Their interest in preserving and improving the use of unitary taxation in *interstate* commerce is appropriate and understandable. What is neither appropriate nor understandable is the Commission's apparent wish to expand the unitary method to *international* commerce where its use conflicts absolutely with established federal and international practice.

26. *Container Corp., supra*, n. 10.

27. See *Container Corp.*, 463 U.S. at pp. 197 — 205 (Powell, J., dissenting).

28. California is a member of the Compact. Cal. Rev. & Tax Code § 38001 *et seq.*

The merits of international use of unitary versus arm's length tax accounting are not justiciable. What is before this Court is whether an individual State may extend its tax base to encompass non-resident foreign persons by a method that is utterly incompatible with United States policy and international agreement. The choice has long since been made by the U.S. Congress and the U.S. Treasury that arm's length separate accounting will be employed in international taxation. The Solicitor General's brief filed in this case, while opposing the grant of *certiorari*, recognized that "[t]he method employed by the United States is known as the 'separate accounting' or 'arm's length' method" and that "[t]he separate accounting method of taxation is employed in the Internal Revenue Code and in the many bilateral tax treaties to which the United States is a party." The Solicitor General further notes that "[t]he separate accounting method is also employed by most other nations for both domestic and international purposes."[29]

The basic reason the unitary method can be applied within the United States to interstate transactions is that the apportionable income base is already established and agreed: consolidated U.S. source income as reported to the federal government. Worldwide unitary, conversely, translates all income, from U.S. and foreign sources, into the currency of the foreign parent, then re-translates that parent company's income into U.S. dollars. Income sourcing rules are ignored because the only income base that can be utilized is that shown in the parent company's annual report consolidating all sources. There is no opportunity for the domestic subsidiary taxpayer to demonstrate that its own operations had no connection with the parent's foreign source income.

A principal defect of the unitary system is the lack of agreement on a standard formula.[30] This is amply illustrated by the

29. Brief for the United States as *amicus curiæ* in Support Of Opposition, p. 2. Treasury regulations, Regs. § 1.482-1T(b)(1), state, "In determining the true taxable income of a controlled taxpayer, the standard to be applied in every case is that of a taxpayer dealing at arm's length with an uncontrolled taxpayer."

30. Apportionment formulas attribute the highest profit to the jurisdiction having the highest factor values. California, a wealthy jurisdiction, uses its high cost standards to skew the formula in its favor. This is totally unacceptable in a global context.

simultaneous passage with SB 671 in California of SB 1176, which instantly changed California's historic three-factor formula by double-weighting the sales factor. This change is clearly designed to shift the incidence of California's tax burden to business groups which have low payroll and property factors but a high volume of sales in California.[31] One can hardly imagine the chaos in international trade were foreign nation to use the unitary method and each devised its own formula. Labor intensive nations might triple-weight numbers of workers employed. Capital intensive nations would surely favor the property factor.

Unitary taxation could not be instituted worldwide without prior agreement on basic principles: the definition of a unitary versus a diverse business; the apportionment formula to be used; treatment of intellectual property rights and transfers; and a standard method for currency translation, to name only the obvious. The arm's length, separate accounting method was conceived to regulate fiscal jurisdiction and prevent double taxation. This method has the advantage of nearly universal agreement on basic principles for more than thirty years; the endorsement of the federal government in the Internal Revenue Code and regulations; and a treaty network that provides a forum for resolving disputes in the form of competent authority proceedings. California's recent attempts to force recognition of its own unique method has produced continuous litigation, protests from foreign as well as the U.S. government, and finally a serious threat of foreign retaliation.

Your *amici* conclude that arguments concerning the supposed advantage of worldwide unitary taxation over the arm's length, separate accounting method have no bearing on the issues in this case. The unitary method as currently practiced by California cannot be reconciled with international or federal practice and its use by a State should be constitutionally restricted to those applications heretofore approved by this Court.

31. This change likely exacerbates interference with foreign commerce since foreign-based affiliated groups are more likely to have larger property investments in research facilities and manufacturing sites as well as higher payroll costs in the domicile of the foreign parent.

CONCLUSION

For the reasons stated, *amici curiæ*, Organization For International Investment and Union of Industrial and Employers' Organizations of Europe urge this Court to reverse the decision below and reinstate the original decision of the California 3rd District Court of Appeal prior to reversal by the California Supreme Court.

Respectfully submitted,

James Merle Carter

Attorney for
Organization for International Investment Inc.
Union of Industrial and Employers'
Confederations of Europe

Of Counsel:
Harris, Carter & Mahota

15 December 1993

APPENDICES

APPENDIX 1-1

MEMBER CORPORATIONS OF OFII

AKZO AMERICA, INC.

ALCAN ALUMINUM CORPORATION

ALCATEL USA CORPORATION

ASEA BROWN BOVERI, INC.

BASF CORPORATION

BATUS INC.

BET INC.

BP AMERICA CORPORATION

BTR, INC.

BUMBLE BEE SEAFOODS, INC.

BUNGE CORPORATION

CENTRAL SOYA COMPANY, INC.

CIBA-GEIGY CORPORATION

ELF AQUITAINE, INC.

FINA OIL & CHEMICAL CO.

FIREMAN'S FUND INSURANCE COMPANY

GLAXO INC.

GRAND METROPOLITAN INCORPORATED

GUINNESS AMERICA, INC.

HANSON INDUSTRIES

HITACHI, LTD.

HOECHST CELANESE CORPORATION

HOFFMAN-LA ROCHE, INC.

CI AMERICAS INC.

INSTORIA, INC.

KLOCKNER NAMASCO CORPORATION

LVMH MOET HENNESSY LOUIS VUITTON INC.

MATSUSHITA ELECTRIC CORPORATION OF AMERICA

APPENDIX 1-2

MINORCO (USA) INC.
NEC USA, INC.
NESTLÉ USA, INC.
PEARSON INC.
PECHNINEY CORPORATION
PHILIPS ELECTRONICS NORTH AMERICA CORPORATION
PILKINGTON HOLDINGS, INC.
RANK AMERICA, INC.
REED PUBLISHING (USA) INC.
RHONE-POULENC
ROLEX WATCH, U.S.A., INC.
ROLLS-ROYCE INC.
RTZ AMERICA
SANDOZ CORPORATION
SCHINDLER ELEVATOR CORPORATION
SCHINDLER ELEVATOR CORPORATION
S.G. WARBURG & CO. INC.
SIEMENS CORPORATION
SKF USA, INC.
SMITHKLINE BEECHAM
SONY CORPORATION OF AMERICA
SOUTHLAND CORPORATION
TETRA LAVAL
THORN EMI INC.
TOYOTA MOTOR SALES, U.S.A., INC.
UNILEVER UNITED STATES, INC.
ZURICH INSURANCE CO.

APPENDIX 2-1

MEMBER FEDERATIONS OF UNICE

VEREINIGUNG OSTERREICHISCHER INDUSTRIELLER - VOI

FEDERATION DES ENTREPRISES DE BELGIQUE - FEB

UNION CENTRALE DES ASSOCIATIONS PATRONALES SUISSES - ZVSAO

UNION SUISSE DU COMMERCE ET DE L'INDUSTRIE - VORORT

EMPLOYERS & INDUSTRIALISTS FEDERATION CYPRUS - OEB

BUNDESVEREINIGUNG DER DEUTSCHEN ARBEITGEBERVERBANDE - BDA

BUNDESVERBAND DER DEUTSCHEN INDUSTRIE - BDI

DANSK INDUSTRI - DI

DANISH EMPLOYERS' CONFEDERATION - DA

CONFEDERATION DES EMPLOYEURS ESPAGNOLS - CEOE

CONSEIL NATIONAL DU PATRONAT FRANÇAIS - CNPF

CONFEDERATION OF FINNISH INDUSTRY AND EMPLOYERS - TT

CONFEDERATION OF BRITISH INDUSTRY - CBI

FEDERATION DES INDUSTRIES GRECQUES - FIG

CONFEDERAZIONE GENERALE DELL'INDUSTRIA ITALIANA CONFINDUSTRIA

IRISH BUSINESS AND EMPLOYERS CONFEDERATION - IBEC

FEDERATION OF ICELANDIC INDUSTRIES - FII

CONFEDERATION OF ICELANDIC EMPLOYERS - CIE

FEDERATION DES INDUSTRIELS LUXEMBOURGEOIS - FEDIL

MALTA FEDERATION OF INDUSTRY - MFOI

APPENDIX 2-2

CONFEDERATION OF NORWEGIAN BUSINESS AND INDUSTRY - NHO

VERBOND VAN NEDERLANDSE ONDERNEMINGEN - VNO

NEDERLANDS CHRISTELIJK WERKGEVERSVERBOND - NCW

ASSOCIAÇÃO INDUSTRIAL PORTUGUESA - AIP

CONFEDERAÇÃO DA INDUSTRIA PORTUGUESA - CIP

ASSOCIAZIONE NAZIONALE DELL'INDUSTRIA SAMMARINESE - ANIS

FEDERATION OF SWEDISH INDUSTRIES - SI

SWEDISH EMPLOYERS' CONFEDERATION - SAF

TURKISH CONFEDERATION OF EMPLOYERS ASSOCIATION - TISK

TURKISH INDUSTRIALISTS' AND BUSINESSMEN'S ASSOCIATION - TUSIAD

ZVAZ PRIEMYSLU SLOVENSKEJ REPUBLIKY

SVAZ PRUMYSLU CESKE REPUBLIKY

APPENDIX 3

September 15, 1993, Statement of the Chancellor of the Exchequer, Rt. Hon. Kenneth Clarke, Q.C., M.P.

I am greatly encouraged to learn that California has passed legislation to modify its unitary tax law. This development is a vindication of the Government's decision to set a definite time limit for the implementation of retaliatory measures. But for the Government's action it is clear that there would have been no progress in California. The approach that California has now adopted has been designed to bring to an end the problem of unitary tax for UK owned companies in California. However, given the defects that remain in the law, it will be important to ensure that the spirit of the new approach is followed in the detailed regulations and in the practical application of the law. The UK will therefore defer retaliatory action and will retaliate only if it is found that the legislation is being applied in a way which exposes UK owned companies to damage from taxation that is inconsistent with the arm's length principle. I am informing Secretary Bentsen accordingly.

While the legislation in California is a significant step forward, on its own it does not provide a complete solution to the unitary tax problem. For a complete solution it will be necessary to have the internationally accepted arm's length principle endorsed, on a permanent basis, as the only valid method of taxing foreign companies in any State. Success for the Barclays' case in the Supreme Court would achieve this. The Government will continue strongly to support Barclays' case. I hope it will succeed. If it does not, the UK will have to retain its retaliatory powers in reserve as a barrier against the possibility that States might damage UK owned companies by the imposition of unitary taxation at some time in the future.

APPENDIX 4-1

Demarche on Unitary Taxation, September 24, 1993, from the Embassy of Belgium, Presidency of the European Community, on behalf of the Member States of the European Community, and from the Delegation of the Commission of the European Communities.

EMBASSY OF BELGIUM
WASHINGTON, D.C.

The Honorable
Warren Christopher
Secretary of State
Washington, D.C. 20520

Dear Mr. Secretary,

We have the honor to convey to you the attached note on unitary taxation on behalf of the Governments of the Member States of the European Community and the Commission of the European Communities.

We avail ourselves of this opportunity to renew to you the assurances of our highest consideration.

s/ Juan Cassiers
Ambassador of Belgium
EC-Presidency

s/ Andreas van Agt
Ambassador of the
Delegation of the Commission
of the European Communities

APPENDIX 4-2

UNITARY TAXATION

1. The Member States of the European Community and the European Commission have the honour to refer to their note of 26 March 1993 in which they expressed their strong opposition to worldwide unitary taxation and urged the United States Government to support the Barclays petition for *certiorari* to the United States Supreme Court. The Member States, together with eight other major trading partners of the United States, subsequently supported the Barclays Petition in an amicus curiæ brief dated 22 April 1993.

2. The Member States and the European Commission note that the State of California has since passed legislation to modify its unitary tax law. While this legislation is an improvement, the Member States and the European Commission do not consider that the unitary tax problem is solved. Worldwide unitary taxation, which is contrary to the internationally agreed arm's length principle, is still the basis of the tax system in California. A complete solution will require the arm's length principle to be established as the only legitimate basis of taxing foreign companies in any state.

3. The Member States and the European Commission therefore continue strongly to urge the United States Government to support the Barclays petition for *certiorari* to the United States Supreme Court.

APPENDIX 5-1

Demarche on Unitary Taxation, October 14, 1993, from the British Embassy on behalf of the Member States of the European Community and the governments of Australia, Austria, Canada, Finland, Japan, Norway, Switzerland and Sweden.

BRITISH EMBASSY
WASHINGTON, D.C.

The Honorable
Warren M. Christopher
Secretary of State
Department of State
7th Floor
Main State Department Building
2001 C Street, N.W.
Washington, D.C. 20520

Dear Mr. Secretary,

With the agreement of the other countries concerned, I have been asked to convey to you the attached note on unitary taxation on behalf of the governments of the member states of the European Community, and of Austria, Australia, Canada, Finland, Japan, Norway, Sweden and Switzerland.

Yours sincerely,

s/ Robin Renwick

APPENDIX 5-2

UNITARY TAXATION

The 12 Member States of the European Communities: Belgium, Denmark, France, Federal Republic of Germany, Greece, Ireland, Italy, Luxembourg, the Netherlands, Portugal, Spain and United Kingdom; and the governments of Australia, Austria, Canada, Finland, Japan, Norway, Sweden and Switzerland ("the 20 countries") have the honour to refer to their brief for the Supreme Court of the United States in the case Barclays Bank plc v. Franchise Tax Board, dated 22 April 1993.

The countries concerned note that, since that date, the State of California has passed legislation to modify its unitary tax law. While this legislation is an improvement, the countries concerned do not consider that the unitary tax problem is finally resolved. Worldwide unitary taxation is contrary to the internationally agreed arm's length principle embodied in the bilateral tax treaties of the United States and disruptive of international economic relations. A complete solution would require the arm's length principle to be established as the only legitimate basis of taxing foreign companies in any state.

The 20 countries regret therefore that, in his brief filed on 7 October 1993, the Solicitor General of the United States does not support the Barclays petition for a writ of *certiorari*.

APPENDIX 6-1

June 30, 1993, Resolution of the Finance Committee of the German Bundestag concerning unitary taxation in the State of California.

The Finance Committee of the German Bundestag has today discussed the problem of unitary taxation as applied in the State of California to the cross-border apportionment of profits between associated enterprises.

The Finance Committee notes that this method of taxation used by the State of California is based on a flat-rate allocation of profits that is inconsistent with the internationally accepted arm's-length principle, that such allocation of profits can result in substantial double taxation and that it imposes disproportionate burdens on enterprises in discharging their tax filing obligations. In the opinion of the Committee, a "water's-edge" rule under which enterprises operating on an international basis can gain exemption from worldwide unitary taxation of their income only on payment of a large fee is also in conflict with the principles of taxation as agreed in the German-American Convention for the Avoidance of Double Taxation.

The Finance Committee notes with regret the departure of the new U.S. administration from the course followed by former U.S. administrations for more than 20 years. The rejection of unitary taxation has always been and still is both a reflection of mutually agreed positions and a necessary means of ensuring, among other things, that economic relations between the United States of America and the Federal Republic of Germany continue to function smoothly and without disruption.

The Finance Committee calls upon the new U.S. administration to return to the common approach adopted by all other OECD

APPENDIX 6-2

countries and to urge the State of California to relinquish, in the interest of avoiding disruptions of international trade, the system of unitary taxation that is rejected by all other industrialized nations.

The Finance Committee requests the German government to take immediate steps to consider the application of retaliatory measures should it prove impossible to achieve a satisfactory solution to the problem of unitary taxation within a reasonable period of time. In making this request, the Finance Committee proceeds on the assumption that it will be possible to reach a satisfactory solution by the end of 1993.

(25)

No. 92-1384

IN THE

Supreme Court of the United States

OCTOBER TERM, 1993

BARCLAYS BANK PLC,

Petitioner,

vs.

FRANCHISE TAX BOARD, An Agency of the State of California,

Respondent.

ON WRIT OF CERTIORARI TO THE COURT OF APPEALS OF THE STATE OF CALIFORNIA IN AND FOR THE THIRD APPELLATE DISTRICT

BRIEF *AMICUS CURIAE* ON BEHALF OF REUTERS LIMITED IN SUPPORT OF PETITIONER BARCLAYS BANK PLC

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QUESTION PRESENTED

Whether California's application of worldwide combined reporting to determine the taxable income of domestic corporations with foreign parents, or foreign corporations with either foreign parents or foreign subsidiaries, is unconstitutional when such application poses discriminatory compliance burdens on such entities.

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BRIEF *AMICUS CURIAE* ON BEHALF OF REUTERS LIMITED IN SUPPORT OF PETITIONER BARCLAYS BANK PLC

INTEREST OF *AMICI*

Reuters Limited ("Reuters"), one of many subsidiaries of Reuters Holdings PLC, a United Kingdom company, supplies news and financial services worldwide. Reuters does business in approximately eighty countries throughout the world. Reuters is a party to litigation with the New York State tax authorities challenging the constitutionality, under the Foreign Commerce Clause, of the very heavy compliance burden imposed upon Reuters by New York State's worldwide reporting requirements.

The New York Court of Appeals decided that case adversely to Reuters on October 12, 1993. *Reuters Ltd. v. Tax Appeals Tribunal*, No. 186, slip op. (N.Y. Oct. 12, 1993). Reuters currently is evaluating whether to petition this Court for a writ of certiorari.

Reuters submits this brief because the instant case presents the same issue of burdensome compliance under California law, and to underscore the importance of that issue to foreign multinational corporations that, as part of their worldwide operations, do business in the United States.[1]

SUMMARY OF ARGUMENT

California's imposition of worldwide combined reporting on multinational corporations doing business in California does not conform to the international standard and imposes a substantial burden on multinational corporations. In the taxation of multinational corporations, it is the international norm that only the corporation's home jurisdiction — and not any other — may require the corporation to restate all of its books and records worldwide in accordance with that country's accounting standards. However, under California's system, corporations doing business in numerous countries throughout the world are required to keep their books and records for all of their worldwide operations not only in conformance with their home country's practice, as the international norm requires, but also in conformance with California's unique tax requirements. The cost of conforming a multinational corporation's books and records to California's tax requirements is substantial, and may even dwarf the tax owed. Moreover, if other countries deviated from the international norm so that multinational corporations were required to restate all of their books and records to conform with the tax and accounting requirements of every country in which they do business, the compliance costs could be so prohibitive that they would prevent many corporations from engaging in international business.

[1] The petitioner and respondent have consented to the filing of this brief.

ARGUMENT

I. REQUIRING FOREIGN MULTINATIONAL CORPORATIONS TO RESTATE ALL OF THEIR BOOKS AND RECORDS IN ACCORDANCE WITH CALIFORNIA'S SPECIFICATIONS VIOLATES THE LONGSTANDING INTERNATIONAL NORM ESTABLISHED TO AVOID THE PROBLEM OF BURDENSOME COMPLIANCE

It is the international norm that a multinational enterprise keep all of its books and records in conformance with the requirements of its home country. It is *not* the international norm that a multinational enterprise keep *all* of its books and records in accordance with the tax and accounting requirements of *every* country in which it does business. Instead, with respect to a non-home country jurisdiction, only the books and records of the multinational enterprise's operations in that country must conform to the host country's requirements. This practice is known as "separate accounting."

In 1933, the League of Nations conducted a study of international taxation that examined the effects of two alternative methods — separate accounting and formulary accounting — to determine the taxable income of a local branch of a multinational corporation. Mitchell B. Carroll, Methods of Allocating Taxable Income, in Taxation of Foreign and National Enterprises, League of Nations, Volume IV (1933). Because worldwide combined reporting of international corporate groups did not then exist, the issue of separate accounting versus formulary apportionment of worldwide income arose in the context of international branch operations. The issue was whether the branch's income considered earned within the host country should be calculated by separate accounting or as a percentage of the worldwide income of the enterprise of which it was a part. The report noted that "separate accounting ... is preferred by the great majority of Governments, and business enterprises represented in the International Chamber of Commerce, as well as by other authoritive groups." *Id.* at 189 (footnotes omitted). The report concluded that separate accounting was a more

appropriate system than formulary accounting for taxing a local branch of a multinational corporation.

> Various Governments which apply the method of fractional apportionment maintain that the total net income shall be computed in accordance with their own legislation, even though only a very small part thereof may be attributed to the local branch. This involves not only determining gross income from sources in one or more foreign countries, but also allowances for business expenses, bad debts, depreciation, losses and other allowable deductions. . . . Its determination under its own law of income clearly arising in other countries would usually be different from the amount determined under such other countries' own laws. Perhaps many establishments of a large foreign enterprise have no direct or even an indirect relationship to the establishment within the taxing State.
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> * * *
>
> The requirements under fiscal or commercial law for maintaining accounts, the differences in accounting methods, in language, in currency and the incidental problems of evaluation and exchange all tend to support the method of separate accounting. Moreover, the Customs requirements of the different countries tend to force a segregation of the business profits realised [sic] therein.

Id. at 188 (footnote omitted).

Today, virtually without exception, the nations of the world – including the United States – determine branch income by separate accounting. "Separate accounting is the method of taxation in use generally throughout the world and is employed by the federal government." Letter from James A. Baker III, Secretary of the Treasury, to Dan Rostenkowski, Chairman, House Ways and Means Committee (March 5, 1986).

There is a sound reason why the international norm requires that a multinational corporation maintain all of its worldwide books and records only in accordance with the tax and accounting standards in its home country. If every country required multinational corporations to recast all of their worldwide books and records to conform with its tax and accounting rules, many multinational corporations likely would be unable to continue to conduct international business. That is why the federal government follows the international norm. California should not be permitted to upset the international equilibrium.

II. REQUIRING FOREIGN MULTINATIONAL CORPORATIONS TO RESTATE ALL OF THEIR BOOKS AND RECORDS TO CONFORM WITH CALIFORNIA'S SPECIFICATIONS IMPOSES AN UNCONSTITUTIONAL BURDEN ON FOREIGN COMMERCE

The state of California applies worldwide combined reporting to determine the taxable income of California subsidiaries of multinational corporations.[2] Pursuant to this approach, the California Franchise Tax Board determined the taxable income of Barclays Bank of California, a California affiliate of Barclays, a multinational corporation, by applying a percentage[3] to the total income of the entire Barclays enterprise. The total income sum included the income from Barclays Bank of California, Barclays Bank International ("BBI"), Barclays Bank Limited ("BBL"), and 50% or greater subsidiaries of BBI and BBL. Consequently, much of the income included in the total income sum was derived from the business of corporations and affiliates outside California and the United States. *Barclays Bank v. Franchise Tax Bd.*, 14 Cal. Rptr.2d 537, 539 (Ct. App. 1992), *cert. granted*, __U.S.__, 114 S. Ct. 379 (1993).

[2] Although the focus of this case is the use of the worldwide income of a corporate group to determine the California income of a separate corporation, the California system of formulary taxation would impose the same burden on a multinational company organized as a single corporate entity with branches in California and elsewhere in the world.

[3] The California Franchise Tax Board determined the percentage by applying the formula described at Cal. Code Regs., tit. 18, § 25128-25136.

California law required Barclays to recast its income earned from all of these entities in conformance with California's tax reporting rules. California's rules incorporate many, but not all of the Federal tax reporting rules. Moreover, a great many of California's tax reporting requirements do not appear in the tax codes or accounting rules of other countries. Consequently, requiring Barclays to restate all of its books and records to conform with California's rules entails considerable compliance difficulties. To cite just a few examples of federal law incorporated into California law:

- 26 U.S.C. § 267 (1988) disallows deductions for transactions between "related" taxpayers. The statute treats certain related persons, as well as some persons who are not literally "related," as related for purposes of the statute. Deductions that are disallowed under this section are often permitted under the laws of many foreign countries. *See* Cal. Rev. & Tax. Code § 24427 (West 1992).

- 26 U.S.C. § 368 (1988) and related sections constitute a complex system of law for determining when corporate combinations are held to produce current income to the constituent corporations, the degree to which corporate characteristics carry over, 26 U.S.C. § 381 (1988), and formula limits on the use of certain carried-over items, 26 U.S.C. § 382 (1988). Transactions qualifying for nonrecognition treatment under foreign law will often be recognized as producing current income under these sections of the code and vice versa. Moreover, foreign law will never mirror the precise and detailed carryover provisions of § 381 and § 382. *See* Cal. Rev. & Tax. Code § 24451 (West 1992).

- 26 U.S.C. § 453 (1988) contains detailed rules that govern when a taxpayer can report sales for periodic payments on the "Installment method." Special rules are provided for among others, dealers, sales between related persons, and revolving credit plans. These rules are also unique to United States taxing systems. *See* Cal. Rev. & Tax. Code § 24667 (West 1993).

- 26 U.S.C. § 988 (1988) creates a highly sophisticated system of taxing foreign currency gains or losses — rules which have not been adopted in any other country. Under these rules, a foreign currency gain or loss attributable to a "Section 988 transaction" receives separate treatment from that given to the gain or loss on the underlying transaction. While California law incorporates Section 988, it has not incorporated amendments to Section 988 made by the Federal Technical and Miscellaneous Act of 1988 concerning dispositions of non-functional currency and transactions involving foreign contracts, future contracts and other instruments. Thus, the California system of computing foreign currency gains and losses is unique — it differs from the federal system and from the systems of *all* foreign countries. *See* Cal. Rev. & Tax. Code § 24905 (West 1992).

The cost of conforming the worldwide books and records of a multinational corporation to these and other requirements is substantial. The trial court found that it would cost Barclays over $5 million to establish, and over $2 million annually to maintain, a system that would allow compliance with California's requirements.

It is little wonder that the United States government has criticized California for its imposition of worldwide combined reporting. In a letter to George Dukmejian, then Governor of California, George Schultz, then Secretary of State, noted the heavy compliance burden that California's system imposes on foreign commerce.

> The administration of the worldwide unitary method of taxation . . . imposes unreasonable and costly compliance burdens on an enterprise which is considered to be part of a worldwide unitary group. . . . [I]n the case of foreign-controlled entities which are not required to keep data under U.S. tax and financial accounting rules on their non-U.S. operations for any other reason, [it] will require costly conversion. . . .

Letter from George P. Schultz, Secretary of State, to George Dukmejian, Governor of California (Jan. 30, 1986).

Worse, the imposition of such costly burdens on foreign corporations clearly is discriminatory. As noted, the international norm requires only that a multinational corporation maintain its books and records in accordance with the tax and accounting standards prevailing in its home country. Because the United States follows this norm, United States corporations that conduct business in California will encounter little difficulty in satisfying California's tax reporting rules; for they already are required to compile the information mandated by California's system to comply with federal tax law. Foreign corporations, however, are not.

The California Court of Appeals recognized that California's reporting system imposes a substantial — and highly discriminatory — burden on foreign-based multinational groups, such as Barclays.

> Foreign-based corporate groups incur greater administrative costs to comply with California's WWCR system than do their domestic-based counterparts. In a nutshell, this distinction between domestic and foreign-based multinationals is a result of the following: while domestic-based multinationals keep most of their records in English, in United States currency and in accord with United States accounting and tax accounting principles, the same cannot be said for multinationals based abroad. For the foreign parent, some of the information may not be available because different nations use different accounting methods. The information that does exist is not always in the language, in the currency, and in accord with the accounting principles just noted. Significant costs are incurred in obtaining the necessary information on a worldwide basis, and translating and transforming it to these modes.
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> * * *
>
> [A]ll witnesses agreed that with customarily and currently available accounting data, literal compliance

> with WWCR requirements is impossible for foreign multi-nationals . . . .

Barclays Bank, 14 Cal. Rptr.2d at 546 (citations omitted).

Consistent with separate accounting, Barclays reports the local operations of its separate national branches or subsidiaries in compliance with local rules. Moreover, consistent with the international norm, the United Kingdom, Barclays' home country, requires Barclays to report its worldwide activities in accordance with the United Kingdom's accounting rules. Requiring that Barclays prepare another set of worldwide accounts for some sixty countries in accordance with United States and California tax accounting rules imposes an unconstitutional burden on foreign commerce.

CONCLUSION

For the reasons discussed above, this Court should reverse the judgment below and declare the California system of worldwide combined reporting unconstitutional.

Respectfully submitted,

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Dated: December 15, 1993.

(26)

No. 92-1384

In The

Supreme Court of the United States

October Term, 1993

BARCLAYS BANK PLC,

Petitioner,

vs.

FRANCHISE TAX BOARD, AN AGENCY OF THE STATE OF CALIFORNIA,

Respondent.

On Writ Of Certiorari To The Court Of Appeal Of The State Of California In And For The Third Appellate District

BRIEF OF JAPAN TAX ASSOCIATION AS AMICUS CURIAE SUPPORTING PETITIONER

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BRIEF OF JAPAN TAX ASSOCIATION AS AMICUS CURIAE SUPPORTING PETITIONER

INTEREST OF AMICUS CURIAE

The Japan Tax Association (the "Association") is a nonprofit and neutral organization whose membership is comprised of approximately 600 Japanese corporations as well as tax scholars and practitioners. Many members of the Association conduct business operations in a large number of countries throughout the world, including the United States. Most of them have subsidiaries engaged in business in the State of California. The Association is engaged in the study of tax legislation and administration both in Japan and abroad and in the publication of the results of such studies. The Association also provides

opinions, when necessary, with regard to tax systems and tax administration.

The issue presented by Petitioner is the constitutionality of the application of the method of corporate income allocation known as worldwide combined reporting ("WWCR") by the Respondent Franchise Tax Board of the State of California to domestic corporations with foreign parents, or foreign corporations with either foreign parents or foreign subsidiaries. This Court reserved resolution of that issue when it considered the constitutionality of the use of WWCR by Respondent to tax the income of U.S.-based multicorporate groups.[1]

Determination of the constitutionality of the application of WWCR to domestic corporations with foreign parents, or foreign corporations with either foreign parents or foreign subsidiaries, is of significant importance to the members of the Association. The decision will impact their future economic and commercial relations with the United States.

On behalf of its members, the Association submits this brief *amicus curiae* in support of the Petitioner.[2]

ARGUMENT

Members of the Association are adversely affected by the Respondent's use of WWCR. Respondent claims that it imposes tax only on the operations conducted by corporations in California. However, the WWCR as applied by Respondent computes taxable income of a corporation in the State of California based upon the income earned

[1] Container Corp. of America v. Franchise Tax Board, 468 U.S. 159, 189 n.26 (1983).

[2] Petitioner and Respondent have consented to the filing of this brief amicus curiae in letters filed with the Clerk of this Court.

by the worldwide operations of all corporations considered to be conducting a unitary business with that corporation, by applying property, payroll and sales factors to apportion such worldwide income. Due to the application of WWCR by Respondent, income which members of the Association earn from business activities solely within Japan and other countries around the world (outside of California) nevertheless is taxed in the State of California. Such income is naturally taxed in the country where it is actually earned. As a result, taxation by the State of California results in double taxation. However, Respondent provides no tax credits for those taxes already assessed upon such income in the foreign jurisdiction where it was earned.

The Association believes that the Respondent's use of WWCR is contradictory to, and incompatible with, accepted international principles of corporate tax assessment and the purpose of double taxation treaties to which the United States is a party, including the Japan/United States Income Tax Treaty ("Treaty"). The internationally-accepted rule for imposing tax on multinational corporate groups is the "arm's length principle," under which the taxable income of each corporate member of the group is computed on the basis of its separate books, records and transactions. The Treaty prescribes the use of the arm's length principle for determining the taxable income of corporate residents of Japan and the United States in their dealings with each other. WWCR, therefore, is contrary to the provisions of the Treaty. Application of WWCR in fact infringes on the basic jurisdiction of each country to impose tax on the income derived from business activities conducted within its borders.

The Association also believes that the Respondent's use of WWCR is an impediment to investment and trade with the United States. A decision by any member of the Association to invest in or expand manufacturing facilities or other business operations in the United States or any other country will depend, in part, upon the tax

burden imposed. If the United States continues to permit double taxation resulting from the application of WWCR, investment in the United States may be seriously impaired.

Furthermore, the Association views compliance with the recordkeeping and filing requirements imposed by WWCR to be extremely difficult. With the proliferation of business operations on a global scale, the necessity to compute profits, property, payroll and sales on a worldwide group basis, particularly according to rules which are unique to the State of California, constitutes an unacceptable burden on business. Although some companies may collect and maintain certain required information in the ordinary course for purposes of public disclosure in consolidated financial statements, the accounting principles and rules applicable in Japan and other countries are often different from those required under WWCR, requiring extensive adjustments to achieve compliance. This compliance burden not only raises non-discrimination concerns under the Treaty but also, as a very practical matter, serves as another serious impediment and deterrent to investment in the United States. The Association also notes that WWCR requires the disclosure to state government authorities in the United States of confidential information obtained from countries around the world and fears that such information might be subject to improper disclosure.

The Association has noted the serious reaction to WWCR of some foreign governments, which are particularly concerned about the discrimination issues arising under WWCR. Although the Association believes that international tax issues, such as those raised by WWCR, should be resolved through careful study and mutual consultations, the Association is deeply concerned that a failure by the United States to reject WWCR may result in retaliation by foreign governments.

The Association is anxious to have the question of the constitutionality of WWCR to domestic corporations with

foreign parents, or foreign corporations with either foreign parents or foreign subsidiaries, resolved before more harm is done to its members' economic and commercial relations with the United States and to prevent continued double taxation of its members. In this regard, the Association understands that the State of California has recently amended its law to resolve certain issues concerning WWCR. The State of California continues to require WWCR in principle. In addition, at least six other states use WWCR in whole or in part. It is possible that other states may adopt WWCR in the future. Therefore, the Association believes that the recent California legislation does not mitigate the serious issues created by the application of WWCR and that, consequently, this case presents a substantial and recurring question of great importance and international concern.

CONCLUSION

The Japan Tax Association asks that Petitioner's request for relief be granted.

Respectfully submitted,

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Dated: December 15, 1993

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BRIEF OF THE MEMBER STATES OF THE EUROPEAN COMMUNITIES (BELGIUM, DENMARK, FRANCE, GERMANY, GREECE, IRELAND, ITALY, LUXEMBOURG, THE NETHERLANDS, PORTUGAL, SPAIN AND THE UNITED KINGDOM) AND THE GOVERNMENTS OF AUSTRALIA, AUSTRIA, CANADA, FINLAND, JAPAN, NORWAY, SWEDEN AND SWITZERLAND AS AMICI CURIAE IN SUPPORT OF PETITIONER

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December 16, 1993

PRESS OF BYRON S. ADAMS, WASHINGTON, D.C. (202) 347-8203

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INTEREST OF AMICI CURIAE

The Member States of the European Communities (Belgium, Denmark, France, Germany, Greece, Ireland, Italy, Luxembourg, The Netherlands, Portugal,

Spain and the United Kingdom) and the Governments of Australia, Austria, Canada, Finland, Japan, Norway, Sweden and Switzerland (collectively, the "Twenty Nations") are major trading partners of the United States. The Twenty Nations comprise more than three-quarters of the membership of the Organization for Economic Co-operation and Development (OECD), the principal economic organization for the developed nations of the world (the United States is also a member), and account for over 95 percent of non-U.S. gross domestic product in the OECD. The Twenty Nations have extensive networks of bilateral double taxation agreements both among themselves and with other nations, including the United States. In their bilateral agreements, and as members of the OECD, the Twenty Nations have uniformly and consistently upheld use of the "arm's length-separate accounting" method of determining income as the proper method to be utilized for purposes of international income taxation.

The question presented in the instant case is whether California's imposition of the so-called worldwide unitary method of taxation on corporations (domestic or foreign) with foreign parent companies is unconstitutional. Resolution of that question is of considerable importance to the Twenty Nations in light of the conflict (explained more fully below) between such method and the internationally accepted arm's length-separate accounting method upon which the Twenty Nations have based their international commercial relations.

The Twenty Nations submit this brief *amici curiae* in support of petitioner.[1]

[1] Petitioner and Respondent have consented to the filing of this brief *amici curiae* in letters filed with the Clerk of this Court.

SUMMARY OF ARGUMENT

The issue of the division of international income for taxation purposes is of fundamental importance to foreign governments generally. The arm's length-separate accounting method is the only internationally agreed upon method for dividing income. It has facilitated growth in international trade and investment, and is adhered to in a wide network of double taxation treaties entered into by the Twenty Nations with the United States and other countries. It is a fact-based standard which comports with economic realities. Far from being easily manipulated and simplistic, as some have argued, it is, in fact, the basis of a sophisticated international tax system.

Imposition by California of its worldwide unitary taxation scheme promotes only disharmony in international relations. It does not seek to divide income in accordance with economic facts, but, rather, by application of standardized formulae. While this may work within the United States where the economy is relatively uniform, it cannot work on an international scale where economic disparities are much larger and fluctuating exchange rates can significantly affect the formulaic allocations.

The Twenty Nations believe that the imposition of worldwide unitary taxation interferes with the longstanding Federal policy of encouraging inward investment because of the uncertainty it creates regarding exposure to double taxation.

The adverse reaction of the Twenty Nations (and others) to worldwide unitary taxation has been con-

sistently expressed since its application by California to foreign-owned multinational groups beginning in the early 1970's. The Twenty Nations believe that this Court should now bring a halt to this type of state interference with the foreign commercial relations of the United States.

ARGUMENT

I. Introduction.

In this brief *amici curiae*, the Twenty Nations wish primarily to inform this Court of the importance to the entire international community of nations of adherence to the arm's length-separate accounting method of determining the proper division of income for international tax purposes. The Twenty Nations align themselves fully with the arguments set forth in the separate brief *amicus curiae* filed by the Government of the United Kingdom with respect to the constitutional issues raised by the instant case.

II. Importance of Division-of-Income Issue to Foreign Governments Generally.

The issue of the proper division for taxation purposes of income earned in international commerce (including income earned from cross-border transactions with third parties or with related corporations established and operating in different countries) is of fundamental importance to the Twenty Nations and, indeed, to foreign governments generally. It affects the competitiveness of national enterprises in international markets, and it impacts on home country revenues both directly (through taxation of income earned there) and indirectly (through the granting of relief from double taxation on income earned elsewhere).

III. Importance of "Arm's Length" Method in International Taxation.

The "arm's length-separate accounting" method contemplates that accounting for profits and losses by members of a multinational group will be made on a separate entity basis. By definition, transactions between completely unrelated parties occur at arm's length and are reported as such. Where transactions occur between related entities in the same multinational group but located in different tax jurisdictions, the income attributable to each jurisdiction will be determined in accordance with the arm's length principle (that is, so that the resulting attribution of income is that which would be expected to result if two unrelated parties dealing wholly independently with each other had engaged in the same or similar transactions under the same or similar conditions). (The term "arm's length method" is frequently used to refer to both the "arm's length principle" and the "separate accounting method.")

The arm's length method was first adopted for use in international taxation by the United States and a number of other nations in the early decades of this century. The method has since been accepted and adopted by all the major developed nations of the world, as well as by the OECD and the United Nations in their model tax treaties and since World War II, in particular, has helped to facilitate the vast growth in international trade and investment.

The arm's length method is the *only* method which has been internationally agreed upon to determine which country should tax the income derived from

the activities of international business.[2] Without that determination, it would not always be possible to reconcile the competing claims of "source" and/or "residence" countries with respect to the taxation of that income.[3] For that reason, the Twenty Nations believe that the importance of the arm's length method in the field of international taxation cannot be overstated.

The arm's length method is inherently factual in its application. The experience of the Twenty Nations over more than sixty years is that the factual inquiry required in applying the arm's length method (which may, of course, result in so-called transfer pricing adjustments being made with respect to particular intragroup transactions in order to place them on an arm's length footing) produces the most equitable results for all concerned—both nations and taxpayers.[4]

Because it relies so heavily on the facts and circumstances of each case, the arm's length method is

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[2] The Twenty Nations understand that there is considerable supporting testimony to this effect in the Trial Record.

[3] There is general agreement among nations that, under the arm's length method, source countries (i.e., the countries where the income-producing activities take place) in principle have the primary claim to tax income arising within their borders.

[4] Transfer pricing methodologies including allocation-type adjustments in certain specific circumstances, are an integral part of the arm's length standard—they do not supplant it, they support it. Double taxation agreements, generally in their Associated Enterprises Article, allow for transfer pricing adjustments which are consistent with the arm's length standard. Furthermore, such provisions are normally supported by the Exchange of Information and Administrative Assistance Article found in such agreements.

said by some to lack precision. However, the experience of the Twenty Nations is that application of the arm's length method allows the most accurate reconstruction in related party transactions of the fair market value of the goods and services produced and sold. Furthermore, the experience gained in the administration of, and in the resolution of disputes arising under, the arm's length method now represents a substantial body of learning. This learning, the Twenty Nations believe, contributes to a sophisticated international taxation system capable of capturing the numerous, subtle nuances of foreign commerce.

The importance of the arm's length method is, therefore, twofold. General agreement on the use and application of the arm's length method has allowed multinational groups of corporations to establish operations in numerous countries with the knowledge that issues of inappropriate double taxation would be addressed on a mutually compatible basis. The arm's length method ensures that the tax revenues of the home countries will not be jeopardized as a result of the extraterritorial effect of taxation policies adopted by other governments, while at the same time allowing the source countries to tax the income actually earned within their countries.

IV. Extensive Worldwide Bilateral Tax Treaty Network Relies on Arm's Length Method as the International Norm.

As noted, each of the Twenty Nations has an extensive network of bilateral income tax agreements. The U.K., for example, has over 90, France 80, Canada 52 and the Netherlands 48. A fundamental feature of such agreements, which is also contained in

the OECD Model Treaty, the U.S. Model Treaty and the U.N. Model Treaty, is a commitment to the arm's length method as the proper standard to be utilized in dividing the income to be derived from intragroup transactions.[5]

Those same agreements also contain what is called the Mutual Agreement Procedure Article (sometimes known as the Competent Authority Article). This Article provides a "safety valve" mechanism that allows the revenue authorities of two competing countries to negotiate disputes that cannot otherwise be resolved.

The competent authority procedure recognizes that differing economic conditions (and different legal and regulatory regimes) will lead to differing economic results. Through direct bilateral negotiations pursuant to their competent authority procedures, the Twenty Nations, and many others, have sought to avoid double taxation and allow for the equitable division of international income for the benefit of both the taxpayers and the fiscs of their respective nations.

V. Effect of Imposition of Worldwide Unitary Taxation.

In contrast to the underlying harmony developed through reliance upon the arm's length method in international commercial relations, imposition by the State of California of its system of worldwide unitary taxation has proved a severe irritant in international relations and has promoted significant disharmony between the Twenty Nations and the United States because, in many instances, it will result either in the double taxation of foreign-owned multinational groups or damage to the fiscs of other nations.

[5] Organization for Economic Co-operation and Development Model Tax Convention on Income and Capital (1992), Art. 9(1); United States Treasury Department's Model Income Tax Treaty of June 16, 1981, Art. 9(1); and United Nations Model Double Taxation Convention between Developed and Developing Countries (1980), Art. 9(1).

The system of worldwide unitary taxation does not attempt to divide income in accordance with the economic facts and circumstances of each individual transaction, as does the arm's length method. Rather, by use of standardized formulae applied to global figures, worldwide unitary taxation apportions income in a way that does not reflect the economic realities of the transactions involved, or the marketplace in which such transactions take place. There is no factual inquiry, and therefore no consideration of the circumstances of individual transactions (whether between related or unrelated parties). There is, rather, a blanket application of standardized formulae to all situations, driven by the assumption that certain uncompensated "flows of value" are more likely to be captured by a formulaic approach than by a facts and circumstances analysis.

California may contend that, in imposing its system of worldwide unitary taxation, it does not tax the income of non-California corporations but only the income attributable to the California part of a unitary business. The Twenty Nations strongly disagree with such a contention. The effect of worldwide unitary taxation is to assign to the California tax base—and therefore to tax—a portion of the group's income earned throughout the world. By definition, therefore, worldwide unitary taxation reaches income earned outside of California. The fact that the formula chosen by California to determine its "fair" portion of that income consists of California-related factors such as

property, payroll and sales does not comport with, and in fact completely ignores, long-accepted international norms for determining income earned in a particular taxing jurisdiction on a separate accounting basis.

Moreover, through use of its three-factor formula—particularly with its proportionately higher wage rates and property values—California may well assign to the Californian part of a unitary business substantially more income than may have been earned there.[6] The Twenty Nations believe that such a result is seriously distortive of economic reality and therefore is inherently inequitable. Indications from this Court that it is willing to intervene only if the apportionment is shown to be "out of all appropriate proportion to the business transacted" are not particularly reassuring. *See Container Corp. of America* v. *Franchise Tax Board*, 463 U.S. 159, 180-181 (1983)

The theory underlying the use of formulae to apportion the income of a unitary business is that each dollar invested in property and wages and each dollar generated from sales produces roughly the same amount of income for the group, and that all of the income of the unitary group accordingly can properly be divided on the basis of the location of its property, payroll and sales. The Twenty Nations understand that the unitary system had its genesis in the taxation of the transcontinental railroads in the later decades

[6] By way of example, a start-up subsidiary of a foreign parent undertaking operations in California might incur significant early losses and yet be taxed on some portion of the worldwide profits of its group because of the manner in which California's apportionment formula operates.

of the nineteenth century. Even one hundred years ago, there were substantial elements of national uniformity within the United States—most notably a single currency. The growth in application of the domestic unitary method of taxation in this century has been mirrored by increasing national uniformity. Within the United States, there is a national minimum wage, national workplace standards and uniform national accounting standards. Congress has established the Federal Reserve System, expressly charged with pursuing national economic and financial objectives, including price stability, stability in the purchasing power of the dollar, and a safe and flexible banking system. The development of sophisticated financial markets ensures that similar businesses throughout the nation have access to capital on equal terms. All of this means that within the United States, the application of a standard unitary apportionment formula is not likely to produce results that are dramatically inconsistent with economic reality.[7]

Because of vastly differing economic and legal conditions among the nations of the world, however, the assumptions of the unitary system are, quite simply, inapplicable on an international scale. In particular, the use of more than one currency in the activities of a multinational group makes the assumption underlying the unitary principle completely inappro-

[7] The Twenty Nations do not in any way intend to comment on how the States divide income within the United States. If such division is by way of unitary formula, however, the formula should not be applied to income arising beyond the "water's edge" of the United States (as has now generally been acknowledged by the State of California in its most recent legislation passed in October 1993).

priate internationally. Exchange rate fluctuations will, for example, affect the allocation of profit by affecting both the numerator and denominator of the apportionment formulae. In other words, changes in exchange rates can lead to a change in the allocation of a multinational group's profits that is completely unrelated to the business activity actually undertaken.[8]

Furthermore, the unitary formula takes no account of variations in wage rates between countries. A corporation may choose to locate a subsidiary in a low wage country in the expectation that operations in that country will, as a result, be relatively more profitable than operations elsewhere. Worldwide unitary taxation turns this economic decision on its head by allocating—simply by application of a formula—some of those profits to high wage jurisdictions.

Moreover, multinationals take account of a wide range of factors in deciding where to locate their subsidiaries. These include the extent to which firms must comply with burdensome local regulations, the availability and cost of finance as determined by the nation's capital market, the quality of the transportation infrastructure, and the availability and cost of natural resources and other factors, such as water and utilities, critical to the production process. These factors vary substantially between countries and they will influence the profitability of firms, which is why close attention is paid to them before a decision to locate in a particular country is taken. Yet the assumption behind worldwide unitary taxation is that all workers, all property and all sales are equally profitable the world over. If this were the case, corporations would be indifferent about where they located their operations.

[8] For example, a change in exchange rates between Country A (in which State A uses worldwide unitary taxation) and Country B, from 1:1 to 1:2, where State A had claimed 50% (10/20) of the income of a group before devaluation, would lead to State A claiming 67% (10/15) of such income after devaluation.

By contrast, a change in exchange rates will affect arm's length calculations only to the extent that transactions take place between the two countries requiring currency to be exchanged. The impact of exchange rate changes on the division of income for tax purposes therefore accords with their true economic impact.

The Twenty Nations are aware that a number of these issues were examined by this Court in *Container Corp., supra.* The majority there found fault with the arm's length method as "subject to manipulation and imprecision, and often ignores or captures inadequately the many subtle and largely unquantifiable transfers of value that take place . . . ." 463 U.S. at 164-165. The Twenty Nations wish to apprise this Court that their experience in constructing and administering an international taxation system that has been based upon the arm's length method for over sixty years has led them to conclude that it is neither easily manipulated nor simplistic. In the context of international income taxation, the Twenty Nations also believe that their extensive experience with, and continuing adherence to, the arm's length method is more relevant to the issues before this Court than the experience of the several states.

In short, the Twenty Nations firmly believe that the enormous variations in economic and legal conditions throughout the world realistically lead to the conclusion that the arm's length method is the only

system capable of reconciling such differences. Those variations render the assumptions on which unitary taxation is premised fundamentally inapplicable on a worldwide basis.

VI. Imposition of Worldwide Unitary Taxation by States Runs Directly Contrary to Efforts of U.S. Federal Government to Encourage Foreign Investment by Providing a Tax Environment Consistent with International Standards.

In the United States, the regulation of commerce with foreign nations has always been the exclusive province of the Federal Government. Foreign commerce includes flows of capital across borders—international investment as well as international trade. The Federal Government has consistently undertaken to attract inbound international investment as that adds to the stock of capital available in the United States. In order to attract such capital, the United States must provide foreign investors with certain assurances, particularly as to how the return on their capital will be taxed and whether it will be taxed in accordance with international standards.

The extensive network of bilateral double tax treaties entered into by the United States, based as it is on a common commitment to use of the arm's length method, is designed to provide assurances for international investors that they will not suffer inappropriate double taxation on the profits from their investments.[9] Similar assurances can be found in the Treaties of Friendship, Commerce and Navigation

[9] *See* prepared statement of Hon. Leslie B. Samuels, Assistant Secretary of the Treasury (Tax Policy) before Senate Foreign Relations Committee, Hearings on Tax Treaties (with Russian

which several of the Twenty Nations have entered into with the United States (all of which were entered into before California began imposing worldwide unitary taxation on foreign-owned groups).

By contrast, the unitary method can actively discourage foreign investment. As U.S. Secretary of the Treasury Blumenthal noted in a letter to Martin Huff, Executive Officer of the California Franchise Tax Board, on February 15, 1977, "The unitary system imposes a substantial compliance burden on multinational corporations. . . . We are aware of cases where this burden has discouraged foreign investment."[10] The "chilling effect" of unitary taxation on investment policy was spelled out even more clearly by U.S. Secretary of the Treasury Baker, who wrote to Chairman Rostenkowski of the House Ways and Means Committee on March 5, 1986:

> The United States is strongly committed to encouraging the free movement of international direct investment capital across national boundaries. State use of the worldwide unitary method is unacceptable because it can adversely affect this clearly articulated federal policy. The United States, as the country hosting the largest amount of foreign direct investment, has gained enormously from the

Federation, *et al.*), October 27, 1993, 103rd Congress, 1st Sess. at 2-4.

[10] Hearings on Tax Treaties with United Kingdom, *et al.*, before Senate Foreign Relations Committee, July 19 and 20, 1977, 96th Congress, 1st Sess. at 412. (Exhibit 37c.) (All references to exhibits are to those in the Joint Stipulation of Facts contained in pages A-36 to A-73 of the Appendices to Petition for a Writ of Certiorari filed in the instant case.)

inflow of foreign investment. If the use by some of our states of the worldwide unitary method inhibits the flow of capital, the economic well-being of the country as a whole would suffer.

Exhibit 46n.

There is an inevitable tension, therefore, between the Federal policy of encouraging foreign investment in the United States and the use by individual States of a taxing scheme which is not consistent with the taxing schemes adopted and utilized by the other nations of the world. That inconsistency introduces considerable uncertainty into the inward investment equation.

VII. Adverse Reaction of Foreign Governments to Worldwide Unitary Taxation is Well-Documented.

Since the late 1970's the Twenty Nations have, sometimes individually and sometimes in concert, expressed their dissatisfaction with worldwide unitary taxation to the various United States Administrations. In addition to a considerable number of diplomatic notes and other formal communications,[11] the U.K. has passed retaliatory legislation,[12] the French and Canadian Governments expressed their concerns when ratifying their double tax treaties with the United States,[13] the Netherlands held up treaty negotiations with the United States from 1984 to 1988, and most

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[11] *See* list in Appendix A hereto and Exhibit 32b., *et seq.*

[12] Now Sections 812-815, Income and Corporation Taxes Act, 1988, (Exhibit 35).

[13] Exchanges of Notes, November 24, 1978 and September 26, 1980 (Exhibits 43 and 42 respectively).

recently, the Finance Committee of the German Bundestag requested the German federal government to consider retaliatory action if the unitary tax issue was not quickly resolved.[14]

The Twenty Nations, consonant with both international custom and the United States Constitution, may only deal formally with the Federal Government. Art. I, § 10, cl. 1; Art. II, § 2, cl. 2; and, Art. II, § 3. Furthermore, the Twenty Nations understand that part of the reason for the vesting of the exclusive power to regulate foreign commerce in the Federal Government was to avoid the "economic balkanization"[15] that would result if each state were to conduct its own foreign economic relations.

If the States are allowed to impose taxes such as worldwide unitary taxation, which result in the international division of income in a manner that is contrary to the fundamental rules of international tax law, the Twenty Nations believe that their commercial relations with the United States are likely to become severely strained. Surely, in the absence of express authorization from Congress, the Framers of the United States Constitution could not have contemplated the taxation of foreign commerce by a state in a way that could lead to such adverse consequences to the Nation as a whole. This Court should reject the position of California and thereby bring a halt to this type of state interference with the conduct of this country's foreign commercial relations.

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[14] Resolution of June 30, 1993.

[15] *Wardair Canada, Inc.* v. *Florida Dep't of Revenue* 477 U.S. 1, 7 (1986) (quoting *Hughes* v. *Oklahoma*, 441 U.S. 322, 325-26 (1979)).

CONCLUSION

For all of the foregoing reasons, the decisions of the courts below should be reversed and California's mandatory worldwide unitary taxing scheme should be held unconstitutional.

Respectfully submitted,

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December 16, 1993

APPENDIX

APPENDIX

Diplomatic Notes and Other Formal Communications

Demarche from Italy, President European Communities, on behalf of the Member States of the European Communities, March 19, 1980;

Demarche No. 51 from the British Embassy, March 25, 1980;

Demarche No. 211 from the United Kingdom, President European Communities, on behalf of the Member States of the European Communities, October 30, 1981;

Demarche No. 692 from the Canadian Embassy, December 22, 1981;

Demarche No. 83 from the British Embassy, May 18, 1982;

Demarche No. 283 from the Canadian Embassy, June 14, 1982;

Demarche from Belgium, President European Communities, on behalf of the Member States of the European Communities, June 29, 1982;

Demarche from Greece, President European Communities, on behalf of the Member States of the European Communities, August 1, 1983;

Aide-Memoire from Government of Japan, August 11, 1983;

Demarche from Greece, President European Communities, on behalf of the Member States of the European Communities, September 23, 1983;

Demarche No. 481 from the Canadian Embassy, September 28, 1983;

Demarche No. 383/83 from Embassy of Australia, November 7, 1983;

Demarche No. 461.20-LJ/hu from Embassy of Switzerland, November 15, 1983;

Demarche from the Federal Republic of Germany, November 28, 1983;

Demarche No. EA-14533 from Embassy of The Netherlands, December 21, 1983;

Demarche from Embassy of Belgium, January 25, 1984;

Demarche from Belgium, President European Communities, supported by the Member States of the European Communities, the European Commission, and the Embassies of Australia, Japan, Canada, and Switzerland, January 30, 1984;

Demarche No. 634 from the Canadian Embassy, February 27, 1984;

Aide-Memoire from Government of Japan, June 6, 1984;

Demarche from Ireland, President European Communities, on behalf of the Member States of the European Communities, December 20, 1984;

Demarche from the Commission of the European Communities and the Embassy of Luxembourg, August 8, 1985;

Demarche from Member States of the European Communities and the Commission of the European Communities, August 30, 1985;

Letter from Ambassador of Spain on behalf of Member States of the European Communities to U.S. Secretary of State, James A. Baker, III, June 30, 1989;

Demarche from the United Kingdom, President European Communities, on behalf of the Member States of the European Communities, July 22, 1992;

Demarche from the Embassy of Belgium, President European Communities, on behalf of the Member States of the European Community, and from the Delegation of the Commission of the European Communities, September 24, 1993;

Demarche from the British Embassy on behalf of the Member States of the European Community and the Governments of Australia, Austria, Canada, Finland, Japan, Norway, Sweden and Switzerland, October 14, 1993.

(26)

No. 92-1384

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On Writ Of Certiorari To The Court Of Appeal Of The State Of California In And For The Third Appellate District

BRIEF FOR BANQUE NATIONALE De PARIS AS AMICUS CURIAE IN SUPPORT OF PETITIONER

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INTEREST OF AMICUS

Banque Nationale de Paris ("BNP") hereby respectfully files this Amicus Curiae Brief in Support of Petitioner Barclays Bank PLC. BNP has received the consent of both parties to file this Amicus brief.

BNP is a French banking corporation which was owned by the French government until November, 1993, when it became a public corporation. It engages in worldwide banking activities both directly and through subsidiaries. For taxable years 1976 through 1988 BNP maintained an agency (an office) in California and filed California franchise tax returns reporting the income shown on the books of the California agency. BNP also owned a California-based banking subsidiary now called Bank of the West ("BOW"), which filed separate California franchise tax returns for taxable years 1976 through 1988. The California Franchise Tax Board ("FTB") has issued Notices of Proposed Assessment of Additional Franchise Tax (NPAs) for 1976-1980 and for 1983-1988[1] to both BNP and BOW based upon worldwide combination of BNP and all of its subsidiaries.

The deficiencies proposed by the FTB and protested by BNP and BOW arise from three separate elements: (1) the FTB calculated combined worldwide income of the BNP unitary group based on foreign financial accounting statements; (2) the FTB disallowed certain expenses (such

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[1] The statute of limitations expired for income years 1981 and 1982 for BNP without issuance of any proposed assessments. Proposed assessments were issued BOW for these years after the expiration of the statute of limitations, but were later withdrawn for that reason.

as the bad debt deduction) contained in the foreign financial accounting statements; and (3) the FTB made certain adjustments to information obtained from foreign financial accounting statements for purposes of computing an apportionment formula.

ARGUMENT

Application of California's worldwide combined reporting system is significantly different for foreign parent groups than for domestic parent groups. These differences include greatly disproportionate burdens of compliance, unequal treatment in the determination of taxable income for identical transactions, and unequal calculation of apportionment factors for identical economic activity. These differences explain why foreign governments and foreign corporations protest California worldwide combination.

FOREIGN GOVERNMENTS AND CORPORATIONS LEGITIMATELY BELIEVE THAT CALIFORNIA'S SYSTEM OF WORLDWIDE COMBINED REPORTING AS APPLIED DISCRIMINATES AGAINST FOREIGN PARENT GROUPS.

The U.K. government has a keen and legitimate interest in the methods used by California to tax both Barclays Bank PLC, a U.K. corporation, and Barclays Bank of California, a California corporation (collectively referred to as

"Barclays").[2] In contrast, the U.K. government has no particular interest in how California taxes a U.S. based enterprise such as Container Corporation of America, whether or not Container owns a subsidiary organized under U.K. law.

The California system of foreign parent worldwide combined reporting offends both foreign governments and corporations because the system creates undue compliance burdens and unfair results for the foreign corporation. The interest of a foreign government with respect to its own domestic enterprises and the unequal treatment imposed by California's system of combined reporting create a situation which compels foreign governments to protest or threaten retaliation.

A. The administrative burden of filing a California worldwide combined tax return is significantly higher for foreign parent combinations.

A worldwide combined tax return requires a taxpayer to record and retain information sufficient to determine income under California tax accounting rules, Cal. Code Regs. tit. 18, § 25137-6(b), and to calculate an apportionment formula, Cal. Code Regs. tit. 18, § 25137-6(c). This information is maintained in the ordinary course of business by U.S. parent corporations and by U.S. subsidiaries of foreign parents. U.S. parent corporations require

[2] The on-going U.S. trade dispute with Japan illustrates the interest of the U.S. federal government in the foreign treatment of domestic corporations and foreign subsidiaries of the domestic corporations.

information from their foreign subsidiaries to prepare consolidated financial statements. The information maintained by foreign parent corporations and by foreign subsidiaries of foreign parent corporations may or may not be recorded under standards required by the Franchise Tax Board regulations, particularly where foreign accounting principles differ from comparable U.S. accounting principles. Moreover, backup documentation is usually maintained in the language of the foreign parent, and a foreign parent and its non-U.S. subsidiaries do not determine their record retention policies based on California tax compliance requirements.[3]

Because foreign parents do not maintain records to file a California worldwide combined report as a matter of course, a significantly higher administrative burden is placed on foreign parents.

Two examples illustrate the disparate burden. The first example illustrates the additional burden faced by a foreign bank in computing income subject to apportionment. Both foreign and domestic banks look to Cal. Code Regs. tit. 18, § 24348(b) for rules determining how banks can take a bad debt deduction. An acceptable method peculiar to California is to allow a deduction for an addition to the reserve for bad debts by an amount needed to absorb anticipated future losses (but for some years not to exceed one percent of outstanding loans.)[4] A

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[3] The tax year in Barclays is 1977; the tax years involved in the current administrative review of amicus commences in 1976.

[4] Alternatively, a taxpayer can compute its addition to the reserve by using a three or six year moving average of loss experience.

bank seeking to apply this "facts and circumstances" test must review the creditworthiness of:

> 1. Its largest loans not to represent less than 10% of its total loan portfolio, *on an individual basis;*
>
> 2. A random selection of a reasonable percentage, not to be less than 5% of a particular class or classes of loans, such class or classes of loans to represent at least 50% of its remaining loan portfolio; and
>
> 3. The historic loan loss experience of the remaining loans determined pursuant to the method allowed in subparagraph 1. of paragraph (A) [i.e., a six year moving average] without consideration of the specific loans, class or classes of loans for which a specific or sampling review was made pursuant to subparagraphs 1. and 2. of this paragraph. Cal. Code Regs. tit. 18, § 24348(b)(3)(C). (Emphasis added.)

As applied to Barclays, where about 1.5% of its worldwide activity is conducted in California and 2% is conducted in the U.S., a specific review on an individual loan by loan basis of 10% of the total worldwide loan portfolio starts the facts and circumstances analysis, followed by review of 5% of classes of smaller loans, *plus* construction of a six year moving average loss experience for the remaining loans. U.S. banks have the data that enables them to shoulder this burden. To obtain comparable treatment with respect to the bad debt deduction, foreign based banks must analyze and produce loan documents, credit reports, internal loan quality review documents, regulatory action, and independent auditor's reports from all over the world. Barclays and its subsidiaries

operated in over sixty countries and territories. Jt. Stip. of Facts, paragraph 8. In the case of Amicus, most of these records are in French, which must be translated by either the taxpayer or the FTB.

The second example illustrates the additional burden faced by a foreign bank in computing its apportionment factors. Both foreign parent groups and domestic parent groups look to Cal. Code Regs. tit. 18, §§ 25137-6(c)(1)(A) and (C) for rules determining the property factor of the apportionment factor. This regulation provides that fixed assets for foreign based taxpayers are valued at original cost as defined under U.S. accounting standards and translated at the exchange rates as of the date of acquisition. However, financial assets are translated at current year-end rates, even though no gain or loss is allowed from historic rates. In general, a U.S. based taxpayer has no problem in determining the original dollar cost and date of acquisition of fixed assets, for those records are maintained in the ordinary course of business. However, for foreign assets of foreign parents, and for subsidiaries of foreign parents, it is necessary to review, and construct if necessary, records that show the date that each fixed asset was acquired. Moreover, the foreign based taxpayer must also determine the original foreign currency cost of each asset (applying U.S. concepts of capitalization of expenses to original cost), and then determine and apply the applicable exchange rate.

The consequences of these differences is that the foreign parent will find it difficult or impossible to compute income subject to apportionment, or to determine the apportionment formula, on a basis that is available to domestic based taxpayers. In contrast to domestic based

taxpayers, foreign based taxpayers are dependent upon the administrative mercy of the FTB, which may or may not be forthcoming, to accept information that is generally not recorded or prepared in a manner consistent with California tax principles. The process is inherently frustrating for foreign parents and for foreign governments.

B. Foreign based taxpayers are taxed on a different measure of income subject to apportionment than domestic based taxpayers, assuming identical transactions and activities.

Cal. Code Regs. tit. 18, § 25137-6(b) provides that the measure of taxable income in a foreign parent combination shall be calculated in the currency in which the parent company maintains its books and records, and then translated into dollars at current exchange rates. Depreciation, depletion, and amortization are translated at historic exchange rates, however. These rules cause identical transactions by a domestic group and a foreign group to be treated differently for California tax purposes where there are changes in the exchange rate.

Take, for example, the bad debt deduction of banks such as Barclays and Amicus. Suppose two loans of equal value are made in 1979, the first a $100 loan by a U.S. bank denominated in U.S. dollars, and the second a Ffr. 400 loan by a French bank denominated in French francs when the exchange rate is 4:1. In 1984 when the exchange rate is 8:1 the loans are written off. The dollar denominated loan (which is how U.S. banks account for loans) produces a deduction of $100. However, the Ffr. 400 loan (which is how the FTB accounts for the loss of the French

bank loan) produces a deduction translated, at 8:1 of only $50. Thus, where the value of the dollar increases with respect to the value of the currency of the foreign country, foreign income is overstated on identical transactions. This result is proscribed by *Kraft General Foods, Inc. v. Iowa*, 112 S.Ct. 2365 (1992), where this Court held that an Iowa statute granting a corporation a deduction for dividends received from a domestic corporation and denying a deduction for dividends received from a foreign corporation facially discriminated against foreign commerce and violated the Foreign Commerce Clause.

Where the value of the dollar decreases with respect to the value of the currency of the foreign parent country, the California regulations cause the foreign income to be understated as compared to U.S. dollar accounting.[5] If exchange rates fluctuate within moderate limits, the distortions may tend to offset each other. However, if foreign income is earned in highly inflationary economies, overstatement of income is inevitable.[6]

[5] A California Court of Appeals has held that a property tax exemption for goods in foreign commerce is invalid, not because there is a discrimination against foreign commerce, but because there is a discrimination in favor of foreign commerce. *Zee Toys, Inc. v. Los Angeles*, 85 Cal.App.3d 763, 149 Cal.Rptr. 750 (1978), *aff'd by an equally divided court sub nom. Sears, Roebuck & Co. v. Los Angeles*, 449 U.S. 1119 (1981). Thus, discrimination against foreign commerce and discrimination in favor of foreign commerce are per se violations of the Foreign Commerce Clause.

[6] The accounting profession has struggled with foreign income translation. *See* generally, *FOREIGN CURRENCY TRANSLATION*, Statement of Financial Accounting Standards No. 52 (Am.Inst. of Certified Pub. Accountants (1981)), which replaced *ACCOUNTING FOR THE TRANSLATION OF FOREIGN CURRENCY TRANSACTIONS AND FOREIGN CURRENCY FINANCIAL STATEMENTS*, Statement of Financial Accounting Standards No. 8 (Am.Inst. of Certified Pub. Accountants (1975)). Under paragraph 11 of FASB 52, financial statements of a foreign entity in a highly inflationary economy is remeasured as if the functional currency were the reporting currency. A highly inflationary economy is defined as one that has cumulative inflation of approximately 100 percent or more over a 3-year period. This remeasurement is necessary to avoid gross overstatement of income earned in high inflation countries. Cal. Code Regs. tit. 18, § 25137-6, *supra*.

The California regulations provide a different measure of income for foreign parents in all cases where an item of income or expense is determined by reference to a tax basis of an item that is valued in a prior period when a different exchange rate existed. Besides depreciation, depletion, amortization and the bad debt deductions, other examples of this inherent defect include the valuation of inventory in computing gross profit from sales and the calculation of gains and losses on the sale of property.

It might be argued that the California scheme of combining foreign parent income, while not perfect, falls within the range of reasonable approximation recognized as acceptable in *Container Corp. of America v. Franchise Tax Board*, 463 U.S. 159 (1983). However, there is a clear distinction between discrimination against foreign commerce in determining income, which is unconstitutional, and rough approximation in apportionment, which is valid. There is no authority or policy that justifies taxing subsidiaries of foreign parents on an income base different from an income base used for taxing a U.S. parent or a

subsidiary of a U.S. parent, assuming identical transactions. A California scheme that allows a $100 deduction for a loss on a loan denominated in dollars, but only a $50 deduction for a loss on a loan denominated in French francs that was the monetary equivalent of a $100 loan when made, facially discriminates and is invalid under *Kraft, supra.*[7]

A fundamental flaw in the worldwide combined return concept applied by the FTB is that foreign parent combinations are taxed on a different measure of income than are domestic parent combinations, assuming identical transactions and changes in the exchange rate.

C. Foreign based taxpayers are subject to discriminatory treatment in the apportionment formula where differences exist in the political economy.

Foreign based taxpayers also are subject to discriminatory treatment in calculation of the apportionment formula. For example, the payroll factor in California is based upon amounts paid to employees. Section 1500 of the Foreign Parent Handbook issued by the FTB (June 1992 ed.) provides that in computing the denominator of the payroll factor for foreign employees not subject to the Internal Revenue Code the determination of whether benefits would constitute income to the employee shall be

[7] For a more extensive discussion of the problems arising when changes in the foreign exchange rate occur, see Roy E. Crawford, "Currency Exchange Problems in California's Worldwide Unitary Taxation," Bulletin of the International Bureau of Fiscal Documentation, August-September 1986, pp. 378-384.

made as though such employees were subject to the Internal Revenue Code. Thus, under a political system where an employer pays employment taxes to the government, which in turn uses the funds to provide enhanced benefits to employees (which would not be taxable under the U.S. Internal Revenue Code), the FTB reduces the amount of actual foreign payroll costs incurred in the denominator of the payroll factor. The difference in political economy results in discriminatory treatment against foreign based taxpayers in computing the apportionment formula.

D. Because most of the economic activity of foreign parents is likely to be outside the U.S., while most of the economic activity of a U.S. parent is likely to occur in the U.S., the increased administrative burden of accounting for foreign income falls disproportionately on subsidiaries of foreign parents. In addition, the distortion in the measure of income arising from exchange rate changes and the discrimination in the apportionment formula applies to a higher percentage of economic activity for foreign parents than for domestic parents.

Only about two percent of the operations of Barclays were in the U.S., and a smaller percentage was located in California. Ninety-eight percent of the economic activity was in foreign countries. In contrast, in *Container Corp. of America v. FTB, supra*, the U.S. activity in this domestic parent combination was about 77%, foreign activity

accounting for about 23%.[8] These percentages illustrate the likelihood that most economic activity of foreign parents with U.S. subsidiaries will be outside the U.S., while most of the economic activity of a U.S. based multinational group will be in the U.S.

There are three practical consequences of this difference. First, the relative burden of converting foreign financial accounting records into California tax accounting reports for Barclays applies to economic activity outside the U.S. 50 times the economic activity in the U.S., while in Container the burden applies to economic activity outside the U.S. that was less than 1/3 of the economic activity in the U.S.

Second, the disparate treatment in determining income where there have been changes in the exchange rate applies to 98% of the economic activity in the income base for Barclays, in contrast to 23% for Container.

Third, the discrimination in the apportionment formula for foreign based taxpayers applies disproportionately to foreign based taxpayers.

CONCLUSION

The Court should reverse the decision of the Court of Appeal of the State of California for the reason that the worldwide combined return applied to foreign parent

[8] In 1965 Container's tax return as filed apportioned 9.8336% of income to California. The NPAs increased income subject to apportionment, and reduced the California share to 7.6528%. *Container Corp. of America*, 463 U.S. at 174-175.

combinations discriminates against foreign commerce and results in an enhanced risk of multiple taxation of foreign commerce. The unfair burdens and uneven treatment of foreign based taxpayers provide the substantive basis for the foreign outcry that has emerged protesting this deviation from international standards.

December 1993.

Respectfully submitted

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INTEREST OF AMICUS CURIAE

The Confederation of British Industry ("CBI") is an independent, non-party political body organized in the United Kingdom. Its members include industrial, commercial, and public sector companies; employer organizations and trade associations that represent individual manufacturing industries; and commercial associations. CBI represents, directly and indirectly, more than 250,000 public and private companies and more than 200 trade associations, employer

organizations and commercial associations. CBI's members employ more than 10 million people.

Many of CBI's members do business in the United States or own subsidiaries that do business in the United States. In 1990, United Kingdom business accounted for almost 27 percent of the $403.735 billion in direct foreign investment in the United States, or $108.055 billion. *Statistical Abstract of the United States*, 12th ed., Government Printing Office (1992). Thus CBI, on behalf of its members, has a substantial interest in state taxation of U.K. companies and their affiliates. State use of unitary taxation on a worldwide basis ("worldwide combined reporting") has a direct and adverse impact on those members of CBI that do business in the United States or have affiliates that do so.

CBI prizes, and its members have a very strong interest in maintaining, positive economic relationships between the United Kingdom and the United States. Worldwide combined reporting is fundamentally destructive of foreign investment in the United States and of broader trade relationships between the United States and other nations, including the United Kingdom. For these reasons, CBI has for many years actively opposed the use of worldwide combined reporting by some States (including California) and has sought to eliminate the negative practical effects – including multiple taxation and excessive and discriminatory compliance burdens – which worldwide combined reporting imposes on foreign

multinationals.[1] Through this brief, CBI seeks to draw the Court's attention to the enormous problems created by worldwide combined reporting for U.K. and other foreign-based corporate groups.

SUMMARY OF ARGUMENT

The United States has a longstanding policy to promote free trade and encourage foreign investment. Adoption of the arm's length method of taxation has been a part of that policy. Worldwide combined reporting discourages foreign investment in jurisdictions that impose it.[2] Worldwide combined reporting acts as a disincentive to investment primarily in three ways. First, because it is incompatible with the method used by all nations of the world to allocate income, it leads inevitably to double taxation. Second, worldwide combined reporting subjects foreign multinationals to extraordinary compliance burdens. The fact that these burdens are not imposed by the arm's length, separate accounting method is a major reason that separate accounting was adopted as, and continues to be, the international standard for the division of income. Finally, worldwide combined reporting introduces uncertainty, inimical to sound business planning.

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[1] The terms "foreign multinational" and "foreign-based multinational" are used herein to refer to a group of corporations that are ultimately controlled by a parent company resident in a foreign country and owned predominantly by non-U.S. citizens.

[2] Hereafter, a jurisdiction imposing worldwide combined reporting will be referred to as a "WWCR jurisdiction."

Because it discourages investment, worldwide combined reporting is directly at odds with United States policy. It has no place in the international sphere.

ARGUMENT

I. INTRODUCTION

A major goal of United States foreign and economic policy has been and continues to be to promote the free international flow of capital and technology and to increase direct foreign investment in the United States. The Advisory Commission on Intergovernmental Relations described the benefits of international trade in the following terms:

> [International] capital investments and income flows contribute significantly to increasing worldwide standards of living. The capital importing or host country benefits from the use of foreign capital in its production processes because the resulting higher capital-to-labor ratios can increase productivity and raise real earnings. The capital exporting country benefits from the rate of return that can be earned on capital employed abroad.

State Taxation of Multinational Corporations, Study by the Advisory Commission on Intergovernmental Relations (Nov. 1982). As early as 1964, the United States government expressed its desire to make evident to the world that the United States welcomes foreign investment. *See Report to the President of the United States from the Task Force on Promoting Increased Foreign Investment in United States Corporate Securities and Increased Foreign Financing for United*

States Corporations Operating Abroad, Government Printing Office (1964).

From a business perspective, three things act as major *disincentives* to investment: (i) a risk of double taxation; (ii) high compliance burdens; and (iii) uncertainty of treatment. Worldwide combined reporting creates all three. Because it deters foreign investment, worldwide combined reporting frustrates United States policy and prevents the Nation from speaking with one voice. This is unconstitutional. *See Japan Line, Ltd. v. County of Los Angeles*, 441 U.S. 434 (1979); *Container Corp. of Am. v. Franchise Tax Board*, 463 U.S. 159 (1983).

II. BECAUSE IT CONFLICTS WITH THE INTERNATIONAL STANDARD, WORLDWIDE COMBINED REPORTING CAUSES DOUBLE TAXATION.

A. Worldwide Combined Reporting is Fundamentally Different from Separate Accounting, the International Standard.

More than 60 years ago, the nations of the world adopted a standard method to divide the income of multinational businesses. That method is arm's length, separate entity accounting.

The basic theory of separate accounting is that only two countries have jurisdiction to tax income: the source country (the country in which income arises)[3] and the residence country (the country of domicile of the taxpayer). The right of the source country to tax income

[3] As a general rule, income is deemed to "arise" where the income-generating activity takes place.

arising therein generally is accepted as primary to the right of the residence country to tax its domiciliaries. Even if a source nation chooses not to impose a tax, the income nevertheless is considered subject to the taxing jurisdiction of that nation, and no other nation (with the exception of the residence country) has the right to tax it.

Under separate accounting, each legal entity (or subdivision thereof, such as a branch) is treated as a separate taxpayer to which taxing jurisdiction applies separately. Jurisdiction of a country to tax any particular legal entity generally does not imply jurisdiction to tax related entities (or other subdivisions). The income and deductions of each legal entity are calculated separately.

Separate entity treatment is applicable regardless of the degree of relationship between affiliates in a group of corporations. However, source nations customarily reserve the right to examine individual *transactions* occurring between related entities (or branches) to determine whether they have been carried out on a basis which realistically reflects what would have occurred had the transaction been between unrelated parties dealing at "arm's length." Where it is found that the transaction was not carried out on an "arm's length" basis, tax administrators may make a deemed adjustment of the terms of the transaction for tax purposes, so as to reflect what the terms would have been had the transaction been at "arm's length."[4] Underlying this right is the principle

[4] The Internal Revenue Service's authority for this adjustment is found in Section 482 of the Internal Revenue Code. The United Kingdom grants the Inland Revenue similar power in Section 770 of Taxes Act 1988.

that income realized on transactions governed by the marketplace is true economic income.

Separate accounting gives taxing pre-eminence to the jurisdiction of the source nation to tax. The residence country carries the burden of eliminating double taxation on the income of its domiciliaries that is subject to tax by another nation, either by granting a credit against its own tax for the source country tax or by permitting a deduction for the income subject to the source country tax.

Under separate accounting, the tax base (the measure of income to which the tax rate is applied) of a foreign multinational in a particular country includes only the profits arising in that country, less the deductions incurred in that country and allowed by that country's law. This approach ensures that taxation reflects actual economic performance in the marketplace in the relevant jurisdiction and also accords with basic business principles.

In contrast, worldwide combined reporting does not respect the separate legal existence of entities. It requires aggregation of the income and deductions of all entities, wherever located in the world, which California deems to be members of a "unitary group." California then applies a mechanistic apportionment formula to allocate to the California taxpayer entity a proportion of the worldwide profits of all the entities in the group.

California determines its share of the group's worldwide income by multiplying that income by a fraction equal to the average of three factors: property, payroll,

and sales (receipts).[5] The numerator of each factor is the unitary group's California property, payroll, or sales, and the denominator is the group's worldwide property, payroll, or sales.[6]

Worldwide combined reporting does not, and by its very nature cannot, take into account differences in profitability. Income is divided according to the monetary value of payroll, property, and sales located in the WWCR jurisdiction, regardless of the actual return derived therein. As described by the United States Assistant Secretary of Treasury Laurence N. Woodworth:

> Implicit in the unitary system is the assumption that profit rates in different units of a corporate family, engaged in different activities and in different locations, are always the same. This is clearly not the case. And when it is not the case, the unitary system will misallocate income. Whenever profit rates are higher in foreign affiliates than in domestic activities, the unitary system allocates too much income to the domestic member or members of the group. The result is tantamount to taxation by a state government of the foreign income of a foreign corporation.

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[5] California recently amended its formula to double-weight the sales factor for most taxpayers. Cal. Rev. and Tax. Code § 25128.

[6] The factors used by those states that use formulary apportionment vary widely. While most use some combination of payroll, property, or sales, they do not weight the factors equally. The rules for determining when a given item (such as a sale) should be attributed to a taxing jurisdiction (and therefore included in the numerator of the factor) also vary greatly. *See* 1 *State Tax Guide, All States* (CCH) ¶ 10-110.

Hearings before the Senate Com. on Foreign Relations, 95th Cong., 1st Sess., 34 (1977).

Thus, the tax base under worldwide combined reporting is computed by (i) aggregating all profits derived from around the world (as computed under the accounting principles of the WWCR jurisdiction), (ii) subtracting the expenses incurred worldwide that are allowed by the law of the WWCR jurisdiction, and (iii) multiplying the result by the apportionment percentage.

Separate accounting and worldwide combined reporting fundamentally conflict.

B. Because Separate Accounting Takes Differences In Profitability Into Account and Worldwide Combined Reporting Does Not, the Interaction of the Two Systems Naturally Results In Multiple Taxation.

The basic objective of devising rules to allocate taxing capacity between different jurisdictions where cross-border trade and investment occur is to ensure both that each nation obtains its fair share of tax and that taxpayers are not subjected to double taxation. The arm's length separate accounting principle was devised and adopted by the United States, the United Kingdom, and other nations to achieve this result. It is the agreed international standard. Its application by fiscal authorities enables double taxation to be avoided. California's application of worldwide combined reporting is incompatible and makes exposure to multiple taxation inevitable.

Separate accounting, by focusing on the actual results of transactions in each jurisdiction, automatically takes

into account differing economic conditions in different source nations. For example, if a multinational enterprise generates the same gross receipts in two countries, but because of differing labor or property costs has lower expenses in one country than in the other, the separate accounting method would reflect the fact that there is more net income in one country than in the other.

Worldwide combined reporting, on the other hand, assigns the group's global income based on the dollar value of property and the dollar amount of payroll and sales in the WWCR jurisdiction. It ignores the differing "rates of return" in different economies. Therefore, where rates of return differ, overlap is inevitable.

It is undeniable that differences in market conditions exist in the world. They result from different labor and property costs, tax rates, other costs imposed on companies by governments including environmental regulation, currency exchange regulations, worker safety and administrative compliance, and a host of other variables.[7] Double taxation is the natural and inevitable result of the use of these incompatible systems.

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[7] The United States in general and California in particular tend to be high cost, low rate-of-return jurisdictions. Payroll and property costs are higher in the United States than in many other nations. *See International Economic Report of the President*, Government Printing Office (Jan. 1977). California, a leader in environmental regulation, causes industries to internalize costs that they would not bear directly in other countries. Moreover, California-style factor apportionment is inherently unfair. By its very nature, a factor formula will attribute the highest profit to countries which have the highest factor values, i.e., rich nations. For this reason alone, worldwide combined reporting could never be accepted on a global basis.

The problem of double taxation is especially severe if the entity operating in the WWCR jurisdiction incurs a loss. Separate accounting would permit the entity to report this loss for tax purposes. Under worldwide combined reporting, if the entity were part of an overall group which realized a profit, the worldwide combined reporting jurisdiction would allocate to itself some of that overall profit. Because the separate accounting jurisdictions in which the profits arose would also source to themselves and tax 100 percent of the profits, the multinational enterprise would pay a double tax.

Because double taxation reduces an enterprise's after-tax return from an investment, the high likelihood of double taxation will discourage an enterprise from investing in WWCR jurisdictions. The disincentive is even greater because worldwide combined reporting will not respect a loss incurred in the jurisdiction. An enterprise otherwise willing to operate at a loss for an initial period to establish itself in a new market faces the deterrent of having to pay tax on the profits of established profitable affiliates elsewhere in the world despite the local loss.

The deterrent is real. As a representative of the United States Department of State noted:

> Foreign governments have informed us that, "The (unitary tax) method can chill international investment and decrease efficient allocation of resources and employment opportunities. In particular, the unitary method can impede foreign entry into the United States market." In their view a unitary tax constitutes " . . . a serious obstacle to the further development of our trade and investment relationships." (Note

signed by the Ambassadors of fourteen of our major trading partners). There have also been calls for retaliation.

Added to this are the statements from foreign business organizations like the Keidandren, which represents over 800 Japanese corporations: "Unitary taxation is the single most serious deterrent to new investment by Japanese enterprises in some states of the United States." The French Patronat, which represents a wide range of the biggest French industries with investment in the United States, described the unitary taxation method in a demarche to our Ambassador in Paris as " . . . not suited to the reality nor to the development of foreign investment, particularly between industrialized countries."

State government officials have also criticized the effects of unitary taxation. The unitary basis of taxation " . . . is contrary to the long established traditional spirit of welcoming foreign investment in the United States . . . We urge those states which have the law to repeal it." (News release of the American States Offices Association, whose members represent 21 states' offices and port authorities in Japan, 12/15/83).

Statement by Allen Wallis (Under Secretary of State for Economic Affairs) Concerning the Chairman's Working Group Report, taken from the Final Report of the Worldwide Unitary Taxation Working Group (August 1984).

III. WORLDWIDE COMBINED REPORTING IMPOSES EXCESSIVE COMPLIANCE BURDENS. THESE BURDENS DETER INVESTMENT.

Businesses necessarily take compliance costs into account in deciding whether to invest in a particular

location. The costs of complying with worldwide combined reporting are excessive, and act as a deterrent to investment.

As described above, separate accounting respects the separate legal existence of entities, and taxes only the profits arising in the taxing jurisdiction. Reporting under separate accounting, therefore, generally requires foreign corporations to report information only on the operations of the entity actually doing business in the jurisdiction.

Worldwide combined reporting, in contrast, requires aggregation of the worldwide income of all entities that are members of a "unitary group", whether or not those entities have any presence or carry on operations in the WWCR jurisdiction. Accordingly, compliance with worldwide combined reporting requires the gathering and reporting of worldwide information for every foreign corporation in the group, not just those doing business in the WWCR jurisdiction. This information must be supplied by those foreign corporations.

Moreover, as noted above, worldwide combined reporting requires that the tax base be determined by computing income under the accounting principles of the WWCR jurisdiction, and by subtracting only those deductions allowed by the law of the WWCR jurisdiction. Reports also must be in English and in U.S. dollars. This is extremely burdensome in practice.

Each country has its own accounting rules, for both financial and tax accounting. An entity doing business in a country typically keeps its accounts using local language and observing local legal and accounting principles. Under worldwide combined reporting, a foreign multinational must

"convert" the accounts of each of its foreign affiliates from the various local rules into U.S. accounting principles and U.S. tax accounting rules. In practice, such "conversion" is impossible without the documentation from which the original reports were created. For example, because depreciation allowances differ under different accounting procedures, a French company would have to add back to its income its French depreciation deduction and then subtract out its WWCR jurisdiction depreciation deduction. To do this, the company would have to know (in dollars) the original cost of the depreciable property and the depreciation deductions already taken. The same is true of many other deductions, such as the bad debt reserve. *See* Roy E. Crawford, *Supreme Court Should Grant Certiorari in Barclays – Even if Clinton Sides with California*, 60 Tax Notes 1503 (Sept. 13, 1993).[8]

Thus, in practical terms, to comply fully with worldwide combined reporting a foreign multinational would have to keep a separate set of books for each foreign corporation using the accounting rules of each WWCR jurisdiction in which any member of the group operates.[9]

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[8] Financial accounting information, even when in U.S. GAAP, is not the same as tax accounting. The California trial court found in this case that using financial accounting information for foreign affiliates led to "inaccurate" income tax results. Appendix A to the Petition for Certiorari, No. 92-1384, at 33. Thus, a foreign corporation cannot use its financial accounts to prepare tax returns.

[9] Benjamin Miller, on the legal staff of the California Franchise Tax Board, has acknowledged that:

> Actual adjustments to income, to be completely precise, would require the preparation of a separate set of books and records on a California tax basis. This is administratively infeasible.

Benjamin F. Miller, *Worldwide Unitary Combination: The California Practice, in The State Corporate Income Tax*, 132, 156 (Charles E. McLure, Jr., ed., 1984).

The deterrent this creates for businesses considering investment in a WWCR jurisdiction easily can be envisioned. For example, assume a foreign multinational that does business in 30 different nations establishes a subsidiary in a WWCR jurisdiction. To file the subsidiary's tax return, the foreign multinational must set up a separate bookkeeping system in each of its 30 different operations which will keep records from those 30 operations in English, in U.S. dollars, and using U.S. accounting principles.

In addition, currency translation introduces particularly burdensome complications. Because currency exchange rates fluctuate over the course of a year, a simple translation of bottom-line amounts into U.S. dollars does not express accurately the dollar equivalent of income earned by different subsidiaries in different currencies during the year. Some sort of contemporaneous translation is necessary, and this must cover translation of each of the thousands (perhaps millions) of transactions engaged in by the subsidiaries over the course of the year.[10]

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[10] The California regulations provide for either an end-of-year exchange rate or a simple average exchange rate. Cal. Code Reg., Title 18, § 25137-6. Neither of these is completely accurate. One problem is that each currency creates its own separate economic world, with its own monetary conditions, inflation rate, and interest rates. Comparing profitability between two territories with different currencies is necessarily inaccurate.

Further, it may be not even be possible for U.S. subsidiaries of foreign-based companies to obtain the required information. A U.S. subsidiary may be unable to convince its foreign parent to develop the data needed to comply with the worldwide method, especially because the method is contrary to the internationally accepted method. Moreover, the foreign parent may be prohibited by foreign law from disclosing the information, for instance in relation to defense contracts with its own government.[11]

The problems compound when a foreign multinational group does business in numerous countries, each with its own currency and its own accounting standards. For a foreign multinational, such as the petitioner here, with more than 98 percent of its business overseas, the cost of complying with a state taxing system like this one is out of all proportion to the profit it can derive from business in the state.[12]

[11] *See Capitol Industries-EMI, Inc. v. Bennett*, 681 F.2d 1107 (9th Cir. 1982), in which the taxpayer argued that it could not disclose information requested by California because the information was confidential under the United Kingdom's Official Secrets Act.

[12] This is not a hypothetical cost. The trial court in this case found the costs to establish a compliance system were $5 million to set up and $2 million annually to maintain. Similarly, in its brief in *Franchise Tax Board v. Imperial Chemical Industries PLC*, Dkt. No. 88-1400, Imperial estimated that its annual cost to establish and maintain the required accounting system was £ 2 million, an amount that exceeded the total amount of franchise tax assessed by California over a ten-year period.

It has been urged that these compliance costs are only the indirect costs of doing business overseas: a foreign taxpayer must expect to comply with the rules of the jurisdiction in which it does business, and foreign taxpayers suffer only because foreign nations do something different.[13]

This argument is fallacious. All nations, including the United States, have espoused separate accounting, in part because it avoids the massive compliance burdens of worldwide combined reporting. Worldwide combined reporting simply could not work as the global standard. If worldwide combined reporting were adopted by every nation in the world, every company in a unitary group would be forced to keep a set of books in the language, currency, and accounting rules of every nation in which *any* member of the group did business. For example, if a multinational group had 60 subsidiaries doing business in 60 different nations,[14] each subsidiary would have to keep 60 sets of records, for a total of 3,600 sets of records. The group's worldwide profits would quickly be devoured in accounting fees and compliance costs. Costs would increase even further if the group had more than one subsidiary or branch operating in a jurisdiction.[15]

[13] This was essentially the position of the California Court of Appeal in its second opinion. *See* Appendix D to the Petition for Certiorari, No. 92-1384.

[14] Petitioner Barclays in this case had more than 220 subsidiaries doing business in 60 nations.

[15] Furthermore, if nations were to adopt worldwide combined reporting, each would undoubtedly vary the factors of the apportionment formula so as to allocate more income to that nation. This would work to the disadvantage of the United

Separate accounting is the only possible method for global use. Worldwide combined reporting is not just a "different" method, but an incompatible method that was rejected by nations as unworkable. It has no place in the international arena.

A business facing the complete revamping of its accounting systems, and the creation of new group data gathering and reporting systems at exorbitant cost, will be deterred from making an investment in a WWCR jurisdiction. The United States' policy of encouraging foreign investment is undermined by state use of worldwide combined reporting.

IV. WORLDWIDE COMBINED REPORTING INCREASES THE LEVEL OF UNCERTAINTY, AND THEREBY DETERS INVESTMENT.

Governments, both foreign and the United States, have recognized the need for a sound international tax structure to foster international free trade and investment by providing business certainty. The arm's length separate accounting standard is the foundation of the resultant accord. Experience has reinforced its soundness in principle and practice.

The networks of international tax treaties give practical effect to the arm's length standard on a bilateral basis. These treaties create mechanisms for the treaty partners to resolve questions of taxing jurisdiction at the level of

States, the world's largest trading nation. This Court must strike down worldwide combined reporting now, to prevent its spread.

the particular taxpayer. Treaties also typically contain a "mutual agreement" procedure to protect taxpayers who believe that the actions of one or both of the treaty partners might result in double taxation. The taxpayers may present their case to the competent authority (the governmental body charged with administrating the treaty) of the treaty partner of which the taxpayer is a resident or national, to resolve the conflict by mutual agreement with the other treaty partner. In some cases, countries may run simultaneous audits of a taxpayer, to ensure that transfer pricing is carried out on the agreed arm's length basis.

Such mechanisms are predicated upon the arm's length separate accounting standard and are unavailable to jurisdictions imposing worldwide combined reporting. Because worldwide combined reporting rests on a different theory from separate accounting, differences cannot be reconciled by adjusting the income or expenses arising from particular transactions. Thus, the double taxation that will almost certainly occur cannot be so relieved.

Worldwide combined reporting also introduces uncertainty in two additional ways. First, because there are no objective guidelines for determining when an enterprise will be deemed "unitary," an enterprise will not know whether a WWCR jurisdiction will seek to subject it to worldwide combined reporting. Further, if an enterprise is deemed to be unitary by a WWCR jurisdiction, such as California, its tax liability in California will depend upon its income, property, payroll and sales not only in California but wherever it does business. Such variables will be incapable of accurate estimation in the course of the everyday decision-making process. Moreover, should the enterprise thereafter wish to invest in

another nation, it would have to consider not only the cost and return of that investment in its own right, but also its potential effect on its tax bill in the WWCR jurisdiction.

CONCLUSION

Worldwide combined reporting, such as the California system at issue in this case, interferes with the United States' longstanding policy of promoting free trade and encouraging foreign investment. It discourages investment by creating a high risk of double taxation, causing uncertainty in taxation, and imposing excessive compliance burdens. It is incompatible with the international standard for taxing multinational enterprises agreed upon by the United States and other sovereign nations. It must not be allowed to stand.

Respectfully submitted,

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No. 92-1384

In the Supreme Court of the United States

OCTOBER TERM, 1993

BARCLAYS BANK PLC,
Petitioner,

v.

FRANCHISE TAX BOARD,
AN AGENCY OF THE STATE OF CALIFORNIA,
Respondent.

On Writ of Certiorari to the Court of Appeal of the State of California in and for the Third Appellate District

AMICUS CURIAE BRIEF ON BEHALF OF THE STATES OF ALASKA, MONTANA, NEW HAMPSHIRE, AND OREGON, IN SUPPORT OF RESPONDENT FRANCHISE TAX BOARD

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INTERESTS OF *AMICI CURIAE*

The States that have joined in this *amicus curiae* brief in support of the respondent State of California Franchise Tax Board all have utilized the unitary business principle and formula apportionment to tax the net incomes of multistate and multinational corporations which conduct business in each State. None of the *amici* utilizes the Arms Length/Separate Accounting method. The State of Alaska applies worldwide combined reporting as the required method of income tax reporting for certain classes of taxpayers,[1] and other of the *amici* States have utilized the worldwide unitary reporting system in prior tax years, or do so pursuant to taxpayer election.[2]

Even States that have in recent years modified the precise worldwide apportionment formula under attack in these petitions nevertheless have significant tax revenues at risk because that formula was applied in prior years for which there are still open tax proceedings. In some cases, these open tax cases date back many years.[3] As a result, cumulatively, billions of dollars are at stake for the States.[4] Even if it is assumed that the *amici* could make

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[1] Alaska Stat. § 43.20.072 applies the worldwide unitary method to taxpayers engaged in the production of oil and gas from leases or property within the State of Alaska, as well as to taxpayers engaged in the transportation of oil or gas by pipeline within the State.

[2] Montana utilizes the worldwide combined reporting method, but also has a "water's edge election" available to taxpayers. Mont. Stat. § 15-31-301 *et seq.* New Hampshire and Oregon both assessed taxes on unitary businesses on a worldwide combined reporting basis prior to 1986. Since then, each State has applied a specific "water's edge" formulation. *See* N. H. Stat. § RSA 77-A, *amended by* § RSA 77-A:2-b (Ch. 153:4, N. H. Laws of 1986). *See also* Or. Rev. Stat. § 314.363, *amended by* § 317.715 (eff. January 1, 1986).

[3] In the case of Alaska, for example, there are open state tax proceedings pending under the worldwide unitary method which include up to twelve years of prior tax assessments, dating back to 1982.

[4] The *amici* all have open taxpayer proceedings which involve prior years' assessments under the worldwide unitary method. The dollars at risk in the different States range from a low of approximately three and one-half million dollars to a high of well in excess of five hundred million. California, of course,

(continued...)

changes in their tax statutes to cure any constitutional defects found by this Court, the matter of taxes already assessed for prior years might not be resolved by such changes. Thus, the refund claims which would surely result from a reversal of the California courts' decisions could disrupt States' finances significantly.

In addition to their direct fiscal interests, the *amici* States all have broader interests in retaining the authority and the flexibility, which has not been circumscribed by Congress, to adopt reasonable apportionment methods and to make changes in their statutory tax structures over time as needed to address their fiscal and administrative needs.[5] Indeed, it was largely because of the administrative difficulties and costs inherent in applying the separate accounting tax method to modern multistate and multinational corporations that almost all States have turned from it to the unitary method for taxing such businesses since World War II.[6] If the Court accepts the petitioners' arguments that national uniformity interests in the separate accounting method rise to the level of a constitutional requirement, the *amici* States' ability to continue to apply reasonable, cost-effective unitary tax systems to meet changing business realities would be stymied. The *amici* States have a strong interest in avoiding such a costly and inefficient result.

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[4](...continued)
has already indicated that it stands to lose over four billion dollars in tax revenues if its worldwide unitary tax scheme is invalidated. Barclays Supp. Br., at 1; Resp.. Br. in Opp. to Cert. in *Colgate-Palmolive*, at 15.

[5] *See* I J. Hellerstein & W. Hellerstein, State Taxation, ¶ 8.03 at 8-29 (2d ed. 1993) (hereinafter cited as "Hellerstein Treatise"). Individual States have adopted variations and refinements of the formula apportionment model, and, as a result, even though the general rule of the unitary business principle is adhered to by nearly all States, no two State tax laws are completely identical. *Id.*, ¶ 9.06 at 9-23, & n. 72.

[6] The Hellerstein Treatise reports that forty-five of the forty-six States (including the District of Columbia) that levy corporate income taxes have adopted some version of the unitary formula apportionment method to apply to multistate and multinational businesses. Hellerstein Treatise, ¶ 9.02, Table 9.1 at 9-8; ¶ 9.06 at 9-23.

SUMMARY OF ARGUMENT

There are few powers more fundamental to State sovereignty than the power to tax. This case involves a challenge to the exercise by California of a prerogative incident to that power, the choice of a rational, administratively appropriate, and neutrally applied method of apportioning the income of a multinational company conducting substantial business in the State. The method chosen by California is based on sound tax accounting valuation concepts that this Court has upheld for more than 70 years: the unitary business principle. Furthermore, in *Container Corp. v. Franchise Tax Bd.*, 463 U.S. 159 (1983), the Court upheld that very California tax method against Foreign Commerce Clause challenges brought by a United States multinational corporation with foreign subsidiary operations.

Thus, Barclays' challenge to the California tax, at its core, rests on the argument that unitary taxation is constitutionally more offensive when applied to a multinational corporation with a parent organized in the United Kingdom, because many nations do not use worldwide unitary taxation and at least the prior Administration of our Federal Government opposed the use of that taxation method by the States on "policy" grounds.

Amici believe that Barclays' arguments are squarely foreclosed by this Court's decision in *Wardair Canada Inc. v. Florida Dept. of Revenue*, 477 U.S. 1 (1986). Here, as in *Wardair*, Congress must be considered, by "negative implication," to have approved the challenged State tax. The facts in this case are remarkably similar to those in *Wardair*. In both *Wardair* and this case, certain foreign nations and business interests, as well as the Executive (in some Administrations), complained that a State tax was contrary to established international "practices," which, the taxpayer argued, reflected "federal policy." However, the relevant international conventions into which the United States has entered, including conventions with the "home" country of the company challenging the tax, do <u>not</u> prohibit the challenged State tax. And the record concerning Congressional lawmaking conduct in the area reflected, at a minimum, Congress' willingness to tolerate the State tax, its "acquiescence." The Court should defer to that Congressional tolerance in this case, as it did in *Wardair*.

Barclays' argument can only be termed extreme in its implications. Barclays suggests that when the Congress has chosen not to take action to preempt, by treaty or legislation, State tax laws viewed by some here and abroad as misguided or burdensome, the Court should fill that legislative void, evaluate foreign policy concerns, and impose as constitutional law a particular form of tax accounting preferred by some foreign governments and business interests. However, the Court has never assumed the role of enforcer of uniformity among the States as to all matters implicating foreign relations. Given the decisions by Congress over more than 20 years not to impose such tax apportionment uniformity on the States, the Court obviously should decline to do so here. Congress has been well aware of the controversy concerning the unitary State taxation method and has not preempted the States despite the clear opportunity to do so.

Barclays is attempting to circumvent the tax treaty between the United States and its "home," the United Kingdom, which clearly allows the State tax of which Barclays complains. Barclays asks the Court to do by way of constitutional law what no act of Congress, treaty, or even executive agreement, has done: to abrogate State taxation rights in the interests of one "policy" view. For the reasons discussed in this brief, the Court should decline that invitation based on its recent precedents and on fundamental precepts of federalism and separation of powers.

ARGUMENT

I. UNITARY BUSINESS APPORTIONMENT HAS LONG BEEN A CONSTITUTIONALLY ACCEPTED METHOD FOR STATE TAXATION OF MULTISTATE AND MULTINATIONAL CORPORATIONS.

Barclays is mistaken to suggest that California's use of the unitary corporate income taxation method represents a recent "intrusion" inconsistent with historical practices and shocking to the international business community. Barclays' Br. 23. This Court recently explained that the "unitary business principle . . . is not a novel construct, but one which [it] approved within a short time after the passage of the Fourteenth Amendment's Due Process Clause." *Allied-Signal, Inc. v. Director, Div. of Taxation*, 112 S.Ct. 2251, 2258 (1992).

In *Allied-Signal*, the Court traced the development of the unitary business principle from the late 1800's, when States first began to recognize that there was value in enterprises like railroads and telegraph companies which transcended the worth attributable to their particular property segments located within a State's borders. *Id.* at 2258. In a series of cases beginning in 1897, the Court found that "a State could base its tax assessments upon 'the proportionate part of the value resulting from the combination of the means by which the business was carried on, a value existing to an appreciable extent throughout the entire domain of the operation.'" *Allied-Signal*, 112 S.Ct. at 2258, *quoting Adams Express Co. v. Ohio State Auditor*, 165 U.S. 194, 220-21 (1897).

The unitary business principle was extended to States taxation of corporate income in *Underwood Typewriter Co. v. Chamberlain*, 254 U.S. 113, 120-21 (1920). Only four years later, the Court decided *Bass, Ratcliff & Gretton, Ltd v. State Tax Comm'n*, 266 U.S. 271 (1924), where it extended the unitary principle to the worldwide income of a foreign-domiciled corporation which did its manufacturing abroad but had sales in the United States. *Bass* relied, in turn, on *Wallace v. Hines*, 253 U.S. 66 (1920), which had recognized, in the context of an excise tax, that a State may look to the property of a foreign corporation beyond its borders to "get the true value of the things within it, when they are part of an organic system of wide extent," giving the local property a value above that which it might otherwise possess. *Wallace*, 253 U.S. at 69, *cited in Bass*, 266 U.S. at 282.

These early cases provided the doctrinal foundation upon which States began to rely to apportion the income of unitary businesses. Never, since the 1920's, has the Court suggested that any line must be drawn between multistate and multinational enterprises insofar as the unitary business principle applies. As long as a corporation and its foreign affiliates are truly unitary, a State has a sufficient connection with the whole enterprise to legitimately tax a fair share of the income of the whole attributable to its in-State activities.

The Court reaffirmed the application of the unitary principle to a multinational corporation with foreign subsidiaries in *Mobil Oil Corp. v. Comm'r of Taxes of Vermont*, 445 U.S. 425 (1980), which

held that the unitary principle is "the linchpin of apportionability in the field of state taxation." *Id.* at 439. Mobil challenged Vermont's inclusion of the "foreign source" dividend income of Mobil's subsidiaries domiciled in other countries within the unitary tax base for purposes of Vermont's apportionment formula. The *Mobil* decision repudiated the notion that the foreign source of the corporate income rendered it untaxable. Citing *Bass*, the Court held that it "has applied the same [unitary-business] rationale to businesses operating both here and abroad . . . ." *Mobil*, 445 U.S. at 438. Rejecting the taxpayer's argument that the source of the income was determinative, the Court ruled that the unitary nature of the underlying business, and not the corporate form, was critical. *Id.* at 440.

California's use of the unitary business principle was specifically upheld as applied to the income of foreign-based subsidiaries of a multinational corporation in *Container Corp. v. Franchise Tax Bd.*, 463 U.S. 159 (1983). In *Container*, the Court noted that it had "long ago upheld the constitutionality of the unitary business/formula apportionment method, although subject to certain constraints. The method has now gained wide acceptance, and is in one of its forms the basis for the Uniform Division of Income For Tax Purposes Act ...." *Id.* at 165.[7]

Most recently in *Allied-Signal, Inc. v. Director, Division of Taxation*, 112 S. Ct. 2251 (1992), the entire Court reaffirmed the constitutionality of the unitary business principle as a viable, and even preferred, method for distinguishing between income generated within a State, which is taxable, and income generated without, which is not. *Id.* at 2261-63. In light of the long history of consistent approval of the unitary method, the Court in *Allied-Signal* concluded: "Indeed, if anything would be unworkable in

[7] By the 1950's, so widely embraced by States was the basic unitary apportionment approach, albeit with a number of local variations, that the National Conference of Commissioners on Uniform State Laws drafted the model Uniform Division of Income for State Tax Purposes Act (UDIPTA). *See* G. Danvers, *State Income Taxation of Multijurisdictional Corporations: An Historical Perspective*, 22 Duquesne Law Rev. 937, 954-55 (1984). UDIPTA, and its successor Multistate Tax Compact, which embodies UDIPTA's principles, is by far the dominant method of corporate income taxation under State laws. *See* Hellerstein Treatise, ¶ 9.06 and Table 9-2, at 9-24.

practice, it would be for us now to abandon our settled jurisprudence defining the limits of state power to tax under the unitary business principle." *Id.*[8]

The unitary apportionment method has at least three major advantages over the separate accounting system when applied to multijurisdictional businesses. First, the unitary method captures the added wealth and value resulting from economic interdependencies of multistate and multinational corporations through their functional integration, centralization of management, and economies of scale. A unitary business also benefits from more intangible values shared among its constituent parts, such as reputation, good will, customers and other business relationships. *See, e.g., Mobil*, 445 U.S. at 438-40; *Container*, 463 U.S. at 164-65. Separate accounting, with its emphasis on carving out of the overall business only income from sources within a single State, ignores the value attributable to the integrated nature of the business. Yet, to a large degree, the wealth, power, and profits of the world's large multinational enterprises are attributable to the very fact that they are integrated, unitary businesses. Hellerstein Treatise, ¶ 8.03 at 8-32.[9]

[8] The dissenting justices in *Allied-Signal*, though disagreeing with the majority's application of unitary business standards to the case, also expressly declined to abandon the unitary business principle, recognizing that to do so would open the door to "a corporate shell game to avoid taxation," by allowing taxpayers to engage in "manipulations of corporate structure" to take advantage of separate accounting and the differing tax rates of various jurisdictions in which the unitary business operates. 112 S.Ct. at 2265 (O'Connor, J., joined by Rehnquist, C.J., Blackmun, J., and Thomas, J., dissenting). *See generally* Mirage, *A Solidification of the Unitary Business Principle: Allied-Signal, Inc. v. Director, Division of Taxation*, 46 Tax Law. 541 (1993).

[9] As one commentator has explained:

> To believe that multinational corporations do not maintain an advantage over independent corporations operating within a similar business sphere is to ignore the economic and political strength of the multinational giants. By attempting to treat those businesses which are in fact unitary as independent entities, separate accounting "operates in a universe of pretense; as in Alice in Wonderland, it turns reality into fancy and then pretends it is the real world."

(continued...)

Second, the unitary principle avoids the pitfalls inherent in separate accounting's attempt to determine what prices and values to ascribe to the so-called "arms-length" transactions among parent, subsidiary, and affiliated corporations. Since, for many unitary business groups, insufficient data exists from the open market to impute transfer prices with any reasonable degree of accuracy, the potential for deliberate manipulation by multinational enterprises and large errors in income reporting inevitably exists under the separate accounting system. Hellerstein Treatise, ¶ 8.03, at 8-29, 8-30; G. Weissman, note 10, *supra*, at 51. Apportionment by formula under the unitary business principle does not rely on these sorts of theoretical transfer price calculations and thus avoids errors inherent in the formal separation of what are in fact intra-corporate group transfers. *See Allied-Signal*, 112 S.Ct. at 2261; *Container*, 463 U.S. at 164-65.

Third, separate accounting is extremely expensive for States to administer when applied to unitary businesses because of the need to trace "the myriad of transfers which take place daily, monthly, yearly ...." Hellerstein Treatise, ¶ 8.03, at 8-29; G. Weissman, note 10, *supra*, at 52. Thus, separate accounting has been unpopular with state legislatures and "has become ever less viable in practice and more dubious in principle." Hellerstein Treatise, ¶ 8.03 at 8-29, & n.101.

Barclays concedes that it is a unitary business. Pet. Br. 3; JA-16. Indeed, there are few businesses today in which value is more integrated, more "fluid" among jurisdictions, than international banking and financial services. Both the capital and the expertise of that industry can be and is deployed, to a significant extent, without regard to geographical boundaries, much less corporate structure.[10] Thus, Barclays is a classic subject for taxation by the

[9](...continued)
G. Weissman, *Unitary Taxation: Its History and Recent Supreme Court Treatment*, 48 Albany L. Rev. 48, 50-51 (1983), *quoting* Hellerstein, *The Unitary Business Principle and Multicorporate Enterprises: An Examination of the Major Controversies*, 27 Tax Exec. 313, 317 (1975).

[10] A sampling of reported cases gives a sense of the transjurisdictional scope of Barclays' business. *See, e.g., Torwest DBC, Inc. v. Dick*, 810 F.2d 925 (10th (continued...)

unitary apportionment method which, as discussed *supra*, the Court has long recognized to be not only constitutionally permissible, but in many respects conceptually preferable, for such businesses.

II. *CONTAINER* AND *WARDAIR* COMPEL AFFIRMANCE OF THE CALIFORNIA SUPREME COURT'S UNANIMOUS DECISION UPHOLDING UNITARY APPORTIONMENT OF BARCLAYS' TAX.

Barclays makes only one argument under the Court's basic four-part framework for Commerce Clause review, first articulated in *Complete Auto Transit v. Brady*, 430 U.S. 274 (1977), and expressly extended to this Foreign Commerce Clause context in *Container*, 463 U.S. at 165-66, 170-72 (1983). Barclays argues that its alleged costs of complying with the tax amount to "discrimination" against foreign commerce. California is better situated to respond to that argument than the *amici* States, given its superior knowledge of its taxation scheme and the record below. For that reason, and because Barclays' "discrimination" claim is both foreclosed by *Container* and unsupported by any of the Court's other Commerce Clause tax decisions, *amici* will not address that argument. Instead, their discussion will focus on Barclays' arguments based on the Court's two additional Foreign Commerce Clause concerns.

Where a State tax implicates foreign commerce, the Court addresses two additional considerations. "The first is the enhanced risk of multiple taxation." "The second ... is the possibility that a state tax will 'impair federal uniformity in an area where federal uniformity is essential.'" *Container*, 463 U.S. at 185-86, *quoting Japan Line, Ltd. v. County of Los Angeles*, 441 U.S. 434, 447-48

[10](...continued)
Cir. 1987) (loans by Barclays' Canadian affiliate to Colorado business); *Barclays Discount Bank Ltd. v. Levy*, 743 F.2d 722 (9th Cir. 1984) (loans by Barclays Israeli affiliate to two California diamond merchants); *Barclays Bank D. C. O. v. Mercantile Nat'l Bank*, 481 F.2d 1224 (5th Cir. 1973) (loans by Barclays New York affiliate for Caribbean development project, involving companies in Atlanta, and the West Indies); *Waterways Limited v. Barclays Bank PLC*, 571 N.Y.S.2d 208 (App. Div. 1991) (hotel financing loan by Barclays, "a British banking corporation, authorized to do business in New York," to Bermuda corporations).

(1979). Barclays argues that California's unitary apportionment tax ran afoul of both these Foreign Commerce Clause concerns.

Barclays' arguments are soundly foreclosed by *Container* and the Court's subsequent decision in *Wardair Canada Inc. v. Florida Dept. of Revenue*, 477 U.S. 1 (1986). The California Supreme Court's reliance on *Wardair* in unanimously rejecting Barclays' arguments was entirely justified. *Wardair* is analytically parallel to this case as regards the factors relevant to Barclays' Foreign Commerce Clause challenge, and fully supports the California court's decision. *Wardair* thus deserves detailed attention.

In *Wardair*, a Canadian air carrier challenged a Florida sales tax on aviation fuel used by the carrier solely for international flights to and from Florida. The Florida Supreme Court, reversing the trial court, held that a U.S.-Canadian Agreement did not preempt the State tax, and that the tax was valid under the Foreign Commerce Clause because the Agreement's limitation only on national taxes reflected the Federal Government's decision not to prohibit States from imposing such taxes. Thus, the Court rejected the contention that the tax "prevents our federal government from speaking with one voice." *Department of Revenue v. Wardair Canada, Ltd.*, 455 So. 2d 326, 329 (Fla. 1984).

In an opinion written by Justice Brennan for a seven person majority, this Court affirmed the Florida Supreme Court, ruling that the Florida tax was not preempted by federal law and did not violate the Foreign Commerce Clause. While *Wardair* involved a tax on aviation fuel, not a corporate income tax, its clarification of the Foreign Commerce Clause analysis is directly pertinent. *Wardair* compels the conclusion that the Court's earlier decision in *Container* upholding the application of California's unitary tax to a multinational unitary business with a parent incorporated in the United States should also extend to Barclays, a multinational unitary business with a parent incorporated outside of the United States.

While *Container* did not present, and therefore left open, the question whether its ruling would control where a multinational unitary business has a foreign parent, the logic of *Container* fully applies to Barclays. Thus, understanding its need to distinguish *Container*, Barclays argues that California's unitary tax is unconstitutional because it has been objected to by prior

Administrations of our Federal Government (though not by the present Administration)[11] and by other nations.

Wardair rejected the same argument. *Wardair* was explicitly not a negative or dormant Commerce Clause case, but instead set clear standards for determining whether the lawmaking actions of the Federal Government should be considered to imply permission for a particular State tax. In doing so, *Wardair* reaffirmed Congress' controlling role in Commerce Clause analysis. *Wardair* thus rejected the notion, derived by some from *dicta* in *Container*, that a State tax is invalid under the Foreign Commerce Clause simply because the tax is considered by the Executive Branch to be inconsistent with international practices and to present an impediment to the conduct of foreign affairs.

The United States filed a brief supporting Wardair's request for review by this Court. Brief for the United States as *Amicus Curiae*, No. 84-902 (filed Sept. 17, 1985) (hereinafter "*Wardair* U.S. *Amicus Curiae* Br. I"). The United States took the position that Florida's tax was "inconsistent with strongly articulated federal policy in this area and with accepted international practice," and argued that, under *Japan Line*, the tax "should be invalidated." *Id.* at 9, 22-35. The United States further argued that international aviation was governed by a pattern of treaties and other agreements which recognized a "policy" of exemptions for "instrumentalities of international air traffic," including aviation fuel, from taxes levied by both national governments and their political subdivisions. The United States said that this policy was recognized by a 1966 Resolution of the International Civil Aviation Organization, and had been "substantially implemented" by "virtually all nations" party to the Chicago Convention, a major international aviation convention to which the United States and 156 other nations were parties (hereinafter "ICAO Resolution"). *Id.* at 10-13. The United

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[11] Prior Administrations objected to the tax on "policy" grounds and thus supported Barclays' constitutional challenges to the tax in the California courts. However, the present Administration filed an *amicus* brief urging this Court not to accept review of the California courts' decisions rejecting those challenges to the tax. The Administration also has not filed an *amicus* brief in this Court supporting Barclays. Barclays' position is now little different from that of the taxpayer in *Container*. *See Container*, 463 U.S. at 195-96 ("Executive Branch has decided not to file an *amicus curiae* brief in opposition to the state tax").

States admitted that tax exemptions actually required by binding international aviation agreements were limited to "national" taxes. However, it noted that bilateral agreements and international aviation convention policies required the United States to "use its best efforts" to secure exemptions from taxes levied by State authorities. The result, the United States said, was a "very strong" expression of federal policy against taxes such as Florida's. *Id.* at 16-20.

Before Florida enacted the tax, the State Department wrote to the Florida Department of Revenue, objecting to the proposed tax and complaining that the tax would undermine the international system of reciprocal tax exemptions, "an important matter affecting U.S. international relations." The Federal Government later received diplomatic notes from approximately twenty-five foreign countries objecting to the aviation fuel tax. Those notes "uniformly" pointed to the "international consensus" and "established international practice" of granting reciprocal tax exemptions under the 1966 ICAO Resolution and bilateral aviation compacts. Some of those notes explicitly raised the possibility of retaliatory taxation. They urged the Federal Government to take the steps necessary to eliminate the Florida tax, because of the "damage that a proliferation of such taxes would cause to international aviation." *Id.* at 20-22 & App. 1a-58a.

After this Court accepted review in *Wardair*, the United States filed a second brief on the merits supporting Wardair's challenge to the Florida tax. Brief for the United States as *Amicus Curiae* in Support of Appellant, No. 84-902 (filed Dec. 26, 1985). That brief reiterated the arguments stated in the United States' first *amicus* brief and stressed the concerns that: the tax would invite retaliatory taxation against U.S. air carriers which would be felt by the nation as a whole; that U.S. carriers might be subjected to a variety of other discriminatory measures abroad; and that the tax would undercut negotiations by the United States with other nations to rectify such discrimination, frustrating the federal objective of achieving and maintaining reciprocal tax advantages. *Id.* at 9-10.

A. Under *Wardair*, A Federal Policy Must Have The Force Of Law To Invalidate A State Taxation Method.

In *Wardair*, the United States and other *amici* made the same argument that Barclays makes here: that "federal policy" required invalidation of the tax.[12] That policy, they argued, was "manifested" by international practices reflected in (1) a Chicago Convention on International Civil Aviation, to which the United States and 156 other nations were parties; (2) the Resolution, adopted November 14, 1966, by the ICAO, an organization of which the United States is a member; and (3) more than 70 bilateral agreements dealing with international aviation into which the United States had entered with various foreign countries.

The Court rejected that contention in *Wardair*. The Court noted that there was an "international aspiration" to eliminate such State taxation of international aviation, but held that "the law as it presently stands acquiesces in taxation of the sale of fuel by political subdivisions of countries."[13] The Court's conclusion was based principally on the fact that while the United States was a party to the Chicago Convention and more than 70 aviation treaties, "in not one of these agreements has the United States agreed to deny the States the power asserted by Florida in this case." *Wardair*, 477 U.S. at 11. That ruling could not be more pertinent here. As discussed *infra*, in <u>none</u> of the numerous income tax treaties to which the United States is a party has it agreed to "deny the States the power" to use worldwide unitary apportionment in their corporate tax schemes.

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[12] More than 40 international air carriers filed *amicus curiae* briefs in *Wardair* urging the Court to invalidate the Florida tax.

[13] *Wardair* made it clear that international opposition to a State tax as "inconsistent" with international practices, conventions, or resolutions cannot serve to invalidate the tax, absent some prohibition having the "force of law." 477 U.S. at 10-12. The Court recently reemphasized this point in *Itel Containers Int'l Corp. v. Huddleston*, 113 S.Ct. 1095 (1992), where it refused to invalidate a State tax on international container leases, politely declining the requests of several nations to do so in light of "international practices." <u>Id</u>. at 1100-01 ("with all due respect" to other nations' positions, the Court adheres to the view that Container Conventions do not prohibit tax challenged by Itel).

The Court acknowledged that the ICAO Resolution "undeniably does endorse an international scheme whereby fuel would be exempt" from a State tax like that imposed by Florida. *Id.* at 11. However, the Court refused to consider that Resolution to establish a federal policy sufficient to invalidate the tax, because it "has not been specifically endorsed, let alone signed, entered into, agreed upon, approved, or passed by either the Executive or Legislative branch of the Federal Government. In other words, no action has been taken to give the Resolution the force of law." *Id.* at 12. That principle applies in this case: no federal "policy" having "the force of law" prohibits State worldwide unitary taxation.

B. Congress May, By Negative Implication, Permit A State Tax Affecting Foreign Commerce, Eliminating The Need For Negative Foreign Commerce Clause Review.

Equally critical in this case is *Wardair's* ruling upholding the Florida tax on the grounds that Congress "affirmatively acted, rather than remained silent, with respect to the power of the States to [impose the tax], and thus that the case does not call for dormant Commerce Clause analysis at all." *Wardair*, 477 U.S. at 9. That ruling was not based on express authorization by Congress, but on the "negative implications" drawn from aviation treaties and conventions. The Court reasoned that "the negative implications of [provisions of the Chicago Convention] support recognizing Florida's power to tax; certainly, the provision demonstrates the international community's awareness of the problem of state and local taxation of international air travel, specifically aviation fuel, and represents a decision by the parties to that Convention to address the problem by curtailing and limiting only some of the localities' power to tax, while implicitly preserving other aspects of that authority." *Id.* at 10.

Similarly, "[b]y negative implication arising out of more than 70 agreements entered into since the Chicago Convention, the United States has at least acquiesced in state taxation of fuel used by foreign carriers in international travel." *Id.* at 12. The Court found especially persuasive the fact that an agreement between the United States and Canada, Wardair's corporate domicile, was among those that "acquiesced" in such State taxation. *Id.* at 11-12. The Court

held that these "negative implications" supported the conclusion that Congress had "affirmatively decided to permit the States to impose these sales taxes on aviation fuel." The Court held that it thus did not even need to reach the issue whether negative Foreign Commerce Clause analysis would require invalidation of the Florida tax. *Id.* at 12-13.

C. Congress Has Repeatedly Been Presented With The Issue Whether States Should Be Prohibited From Taxing Multinationals On A Worldwide Unitary Basis, And Has Repeatedly Declined To Do So.

There is no doubt that similar "negative implications" from Congress' consideration of income tax treaties and legislation compel the conclusion here that Congress must be considered to have decided to permit States to tax multinational unitary businesses using worldwide unitary apportionment.

1. United States Income Tax Treaties Reserve State Taxation Authority Over Foreign Multinationals.

The Executive Branch may well have had foreign policy concerns with State worldwide unitary taxation and may well have sympathized with complaints by other nations, notably the United Kingdom, about that taxation method. However, the U.S. Model Income Tax Treaty and <u>every</u> income tax treaty ratified by the United States reflect a clear federal policy that a State's right to use that tax method should not be surrendered to international criticism, even in the name of international conformity.

The U.S. Model Income Tax Treaty, adopted in 1977, provides that only taxes imposed by the United States at the <u>federal</u> level are governed by treaty provisions that affect unitary taxation. 1977 U.S. Model Income Tax Treaty, Art. 2., *reprinted in* 5 R. Rhoades & M. Langer, Income Taxation of Foreign Related Transactions, §92.02 (1993) (hereinafter "Rhoades & Langer"). A proposed new Model Treaty, the 1981 Draft U.S. Model Income Tax Treaty, similarly extended such restrictions only to federal taxes. *Id.*, §93.02. Both Models were used as the basis for United States

income tax treaty negotiations. Neither imposes any restraint on unitary taxation by the States.[14]

The absence of such restraints on State taxes was not inadvertent. Assistant Secretary of the Treasury for Tax Policy, Donald Lubick, testifying before the U.S. Senate with respect to the United States-United Kingdom Treaty, explained that the U.S. Model Treaty was intentionally drafted so that "local U.S. taxes are not covered because it is unlikely that the United States would consent to the ratification of any treaty provision that restricted the rights of the ... states to impose their own taxes." International Tax Treaties: Hearing Before the Sen. Com. on Foreign Relations, 96th Cong., 1st Sess., at 112 (1979).[15]

Consistent with the policy reflected in the U.S. Models, none of the income tax treaties approved by the U.S. Senate and ratified has included any restrictions on the right of States to impose corporate income taxes on a worldwide unitary basis. There are currently more than forty-five such treaties in force. *See* 3 Rhoades & Langer, *supra*, §15.00 *et seq*., §16.11.

It is important to note that a number of treaties cover certain sub-national taxes of the other nation, though covering only "Federal" taxes of the United States. Such treaties are in force, for

[14] During the Senate's consideration of the United States-United Kingdom Treaty, discussed *infra*, the Treasury Department explained that it had used an informal "model" as the basis for negotiations for years. In 1976, a decision was made to codify the U.S. Model; it was published the following year. The Model treaty was "sent to potential treaty partners prior to the commencement of negotiations," and served "as the discussion draft during the first round of negotiations." S. Exec. Message Q, 96th Cong., 1st Sess., App. C, at 45 (1979). While the 1981 Draft Model was never finalized, it was used as the "actual" U.S. Model in some negotiations. 5 Rhoades & Langer, *supra*, §93.00.

[15] The U.S. Model Treaty was published following the 1977 publication of a revised Model Convention by the Organization of Economic Cooperation and Development ("OECD"), of which the United States is a member. The U.S. Treasury revised the U.S. Model to conform to the OECD Model, "where possible." S. Exec. Message Q, 96th Cong., 1st Sess., App. C, at 45 (1979). The 1977 OECD Model covers both national taxes and those imposed by a nation's "political subdivisions or local authorities." 5 Rhoades & Langer, *supra*, §90.02. Again, the decision that the U.S. Model would not cover State taxes reflects a clear policy decision. It is one of the "important differences between the two models." *Id.*, §§94.00, 94.02 (comparison of OECD and U.S. Models).

example, between the United States and Belgium, China, Finland, Iceland, Italy, Norway, Sweden and Switzerland.[16] Those treaties were entered into over a long period of time, both before and after the U.S. Senate's consideration of the United Kingdom treaty. They reflect the fact that the United States has long been well aware of the issue of extending tax treaty restrictions to sub-national, including State, taxes. They highlight the policy of the United States, embodied in the U.S. Models and every ratified U.S. income tax treaty, not to agree to any such restrictions on the States.

The only tax treaty that the United States even considered ratifying which included restraints on State unitary taxation was the United States-United Kingdom treaty known as the Convention for the Avoidance of Double Taxation ("UK-2 Treaty"). *See* 124 Cong. Rec. S18404, S18408, S18421 (1978) (proposed treaty's coverage of State taxation was a "new provision, not found in other United States tax treaties"). Article 9, section 4 of the treaty, as originally transmitted to the Senate for advice and consent, "would have limited the rights of States to tax British multinationals using the worldwide combination unitary method of apportionment of income." Staff of Joint Comm. on Taxation and Senate Comm. on Foreign Relations, 96th Cong., 1st Sess., Tax Treaties: Steps in the Negotiation and Ratification of Tax Treaties and Status of Proposed Tax Treaties 4-5 (Joint Comm. Print 1979).

The Senate held hearings and extended debates concerning the relative merits of unitary and separate accounting apportionment methodologies, the States' use of unitary apportionment, and the

[16] *See* Belgium, T.I.A.S. No. 6073, Art. I, (entered into force Aug. 29, 1966) (covers "communal supplemental" taxes); China, K.A.V. 313, Art. 2 (entered into force Jan. 1, 1987) (covers "local income tax"); Finland, T.I.A.S. No. 7042, Art. 1, (entered into force Feb. 28, 1971) (covers "communal tax"); Iceland, T.I.A.S. No. 8151, Art. 1 (entered into force Dec. 26, 1975) (covers "municipal income tax"); Italy-2, T.I.A.S. No. 11064, Art. 2 (entered into force Nov. 30, 1985) (covers "local income tax"); Norway-2, T.I.A.S. No. 7474, Art. 1 (entered into force Nov. 29, 1972) (covers "municipal taxes on income," as well as "municipal taxes on real property"); Sweden-1, T.S. 958, 11 Bevans 809, Art. I (entered into force Nov. 14., 1939) (covers "communal income tax"); Switzerland-1, T.I.A.S. No. 2316, Art. I (entered into force Sept. 27, 1951) (covers "federal, cantonal and communal taxes on income").

appropriateness of restricting the States from using that tax method in the UK-2 treaty. *See, e.g.*, 124 Cong. Rec. S16892-99, S18400-30, S18651-70, S18665-67 (1978). The Senate refused to consent to the Treaty with those restrictions on the States, instead reserving its consent pending renegotiation of relevant provisions to preserve State taxation rights. *See* 124 Cong.Rec. S18670, S19076 (1978) (Senate consent with reservation by 82 to 5 vote). The Third Protocol to the Treaty thereafter negotiated limited its scope to "Federal income taxes." 31 U.S.T. 5669, 5709-13; T.I.A.S. No. 9682. The Senate was assured that the Treaty thus would not restrict the States from using worldwide unitary apportionment to tax British-based businesses. S. Exec. Message Q, 96th Cong., 1st Sess., App. B, at 33 (1979) (Treasury Department Technical Explanation of Third Protocol). With the Protocol eliminating that restriction on State taxes, the Senate consented to ratification. 125 Cong. Rec. S17434, S17796 (1979) (Protocol consented to by vote of 98-0). *See also* Staff of Joint Comm. on Taxation and Senate Comm. on Foreign Relations, 96th Cong., 1st Sess., Explanation of Proposed Third Protocol to Proposed Income Tax Treaty Between the United States and the United Kingdom 1 (Joint Comm. Print 1979).

As in *Wardair*, a "negative implication" clearly must be drawn from the U.S. Model Treaties, the many income tax treaties into which the United States has entered, and the UK-2 Treaty. Federal policy, as reflected in foreign policy conduct having the "force of law," has consistently been to retain for the States the right to use worldwide unitary apportionment for corporate taxation, despite the objections to that taxation method by other nations.

And, as in *Wardair*, "most strikingly," the Treaty with the United Kingdom, home to Barclays' parent, does not constrain such State taxation. That "omission ... must be understood as representing a policy choice" not properly overridden by the Court through negative Foreign Commerce Clause analysis. *Wardair*, 477 U.S. at 11-12.

2. Congress Has For Years Refused To Pass Legislation Restricting State Unitary Taxation Of Multinationals.

Barclays argues that its position is supported by the fact that one reason for the Senate's refusal to consent to the original UK-2 Treaty was the view that such restrictions on State taxation rights should not be effected through the treaty process, but instead, if at all, through the normal Congressional legislation process. However, that view merely reflects the Senate's understanding that the proposed restriction on State taxation involved an extremely significant issue of States' rights under our federal system.

The States' sovereign right to devise their own taxation systems is deeply imbedded in the Constitution. During the debate over ratifying the Constitution, for example, Alexander Hamilton wrote that "the individual States should possess an independent and uncontrollable authority to raise their own revenues." With the exception of import and export duties, States "retain [the authority to tax] in the most absolute and unqualified sense; and ... an attempt on the part of the national government to abridge them in the exercise of it would be a violent assumption of power." A. Hamilton, The Federalist, No. 32, at 197-98 (Rossiter ed. 1961).

The Senate's refusal to consent to the UK-2 Treaty without the Protocol excepting State taxation from coverage thus reflected constitutionally appropriate respect for State taxation authority. It was also not an aberration of Congressional policy. Over the ten year period preceding the Senate's consideration of that Treaty, several bills were introduced in Congress that would have restricted unitary apportionment by the States. *See* 124 Cong. Rec. S18416 (1978). Contemporaneously with the Senate's consideration of the UK-2 Treaty, similar bills were introduced that would have effected such restrictions. 125 Cong. Rec. 1748 (1979); S. 983, 96th Cong., 1st Sess. (1979). No such legislation progressed far in Congress and, obviously, none was enacted.

Thereafter, in *Container*, this Court recognized that "Congress has long debated, but has not enacted, legislation designed to regulate state taxation of income," and that at that time there was "pending one such bill of which we are aware." *Container*, 463 U.S. at 196-97, *citing* H.R. 2918, 98th Cong., 1st Sess. (1983). Since *Container*, a series of bills have been introduced in Congress

to prohibit States from taxing multinational corporations on a worldwide unitary apportionment basis. Similar legislative efforts have been made through proposed amendments to general trade legislation. One recent such bill was introduced in the Senate with specific reference to this case and its litigation status in the California courts. *See* 137 Cong.Rec. S13979-81 (1991) (introduction of S. 1775). That bill was simply the latest in a long line of unsuccessful legislation proposing to restrict State unitary taxation, including bills introduced by the Reagan Administration in the years after *Container*.[17]

Succeeding Congresses have considered these bills. Hearings have been held at which Congress has heard testimony both favoring and opposing restricting State worldwide unitary taxation. The objections of other countries and concerns about international trade and investment, as well as the possibility of retaliation, have

[17] President Reagan instructed the Solicitor General not to file an *amicus* brief supporting Container. *See* 20 Tax Notes 901 (Sept. 12, 1983). At that time, President Reagan also did not support federal legislation restricting the taxing powers of the States. Instead, then Secretary of the Treasury Regan appointed a committee to try to resolve the controversy. The resulting Working Group on Worldwide Unitary Taxation, consisting of eighteen governors, chief executive officers, State legislators and other officials, considered issues raised by the unitary method and attempted to agree upon an alternative. After ten months, their final report recommended only that three general principles guide state tax policy, leaving, among other things, the question of taxation of dividends received from foreign corporations to be decided on a state-by-state basis. *See* Miller, A State Perspective on the Worldwide Unitary Taxation Working Group and Task Force, (Part 1 of 3), 1985 Multistate Tax Commission Review 1-9 (November 1985). *See generally* U.S. Department of the Treasury, The Final Report Of The Worldwide Unitary Taxation Working Group (August 1984).

After the Working Group failed to resolve the issue, the Reagan Administration decided to introduce legislation restricting State unitary taxation to a particular "water's edge" formula. 22 Tax Notes 244-45, 670, 1202 (1985). *See* 131 Cong.Rec. S17970 (1985) (introduction of S. 1974 on behalf of Administration); 131 Cong.Rec. H5754 (1985) (introduction of same, as H.R. 3980, in House). Many other bills have been introduced since *Container* that proposed to restrict the States' use of unitary taxation. *See, e.g.*, 135 Cong.Rec. S6331-32 (1989) (S. 1139); 135 Cong. Rec. H780 (1989) (same bill introduced in House); 133 Cong.Rec. H6373 (1987) (H.R. 2990); 132 Cong.Rec. S7488 (1986) (proposed amendment No. 2080 to Tax Reform Act of 1986); 131 Cong.Rec. S5924 (1985) (S. 1113); 131 Cong.Rec. S3170 (1985) (S. 687).

been heard by Congress. Yet, each Congress has declined to enact any such legislative proposals.

Barclays has little response to what the California Supreme Court, in its decision in this case, rightly termed "the din of a 'governmental silence' that cannot be ignored." *Barclays Bank Int'l Ltd. v. Franchise Tax Bd.*, 829 P.2d 279, 294 (Cal. 1992). Barclays' lament that no restrictive legislation has even been voted out of committee merely undercuts its argument. Barclays Br. 9. Two possible conclusions flow from Congressional inaction, over 20 years, with respect to such proposed legislation: 1) Congress does not view the "international furor," in Barclays' phrase, concerning unitary taxation to be sufficiently important even to warrant advancing such legislation to a vote; or 2) Congress may share some concern with that "furor," but considers State taxation rights under our federal system to greatly outweigh that concern.

The same conclusion must be drawn from the record of Congress' consideration of proposed legislative restrictions on State unitary taxation as from the facts concerning U.S. income tax treaties: Congress has decided to allow the States to continue to employ the worldwide unitary taxation method, despite objections by other nations and some Administrations. Congress has chosen not to exercise its constitutional authority to prevent the States from using that method to tax both domestic and foreign-domiciled multinationals. Again, in *Wardair's* terms, Congress should be considered, by "negative implication," to have "affirmatively acted, rather than remained silent, with respect to the power of the States to [use unitary taxation]," so that "the case does not call for dormant Commerce Clause analysis at all," in order to uphold California's unitary taxation of Barclays. *Wardair*, 477 U.S. at 9.

III. CALIFORNIA'S UNITARY TAXATION OF BARCLAYS WOULD ALSO BE CONSTITUTIONAL UNDER THE COURT'S "NEGATIVE" FOREIGN COMMERCE CLAUSE ANALYSIS.

Only if the Court were to conclude that Congress has not adequately revealed its intent to continue to allow State worldwide unitary taxation is it necessary, under *Wardair*, for the Court even to reach the "negative" Foreign Commerce Clause issues raised by

Barclays. Again, the two prongs of that analysis are concerned with "multiple taxation" and "the possibility that a state tax will impair federal uniformity in an area [of foreign relations] where federal uniformity is essential." *Container*, 463 U.S. at 185-86.

Amici will not respond in detail to Barclays' argument that the negative Foreign Commerce Clause's multiple taxation concern requires the Court to invalidate California's tax. *Container* rejected a "double taxation" argument indistinguishable from that made by Barclays. *Id.* at 185-93.[18] While *Container* involved a domestic, rather than a foreign parent, with subsidiaries in foreign countries and the United States, *Container's* logic concerning "double taxation" squarely refutes Barclays' argument.[19]

The only issue that might remain under "negative" Foreign Commerce Clause analysis is the question "whether California's decision to adopt formula apportionment in the international context was impermissible because it 'may impair federal uniformity in an area where federal uniformity is essential,' and 'prevents the Federal Government from "speaking with one voice" in international trade.'" *Id.* at 193 (citations omitted). *Container* further explained that "a state tax at variance with federal policy will violate the 'one voice' standard if it either implicates foreign

[18] Barclays tries to distinguish *Container* on the basis that the taxpayer there did not prove that actual double taxation resulted from California's unitary apportionment. Barclays Br. 32. However, in *Container*, California did "not seriously dispute the existence of actual double taxation, and [the Court] assume[d] its existence for purposes of [the Court's] analysis." 463 U.S. at 187 n.22. *See also id.* at 187 ("the tax imposed ... has resulted in actual double taxation, in the sense that some of the income taxed without apportionment by foreign nations as attributable to appellant's foreign subsidiaries was also taxed by California as attributable to the State's share of the total income of the unitary business of which those subsidiaries are a part").

[19] The Hellerstein Treatise convincingly argues that the "double taxation" doctrine cannot logically be applied in the context of a properly apportioned "State tax imposed alongside taxation by a foreign government," because the Court has no authority to impose limits on a foreign government's taxation scheme, or otherwise to achieve the sort of complete international tax uniformity necessary to avoid double taxation. As *Container's* analysis suggests, the Court should confine its concern to the issue of fair apportionment of an income tax, rather than chase the chimera of international "double taxation." Hellerstein Treatise, ¶8.14[4][a], at 8-143 to 8-145.

policy issues which must be left to the Federal Government or violates a clear federal directive." *Id.* at 194 (citations omitted).

Barclays has not argued that any "clear federal directive" was violated by California's unitary tax. Thus, the only remaining question is whether that tax "implicates foreign policy issues which must be left to the Federal Government."

With respect to this issue, the Court's negative Foreign Commerce Clause analysis has involved interest balancing, as the Court most explicitly acknowledged in the recent decision in *Itel Containers Inter. Corp. v. Huddleston*, 113 S.Ct. 1095, 1103-05 (1993). That facet of the doctrine has been a focus for criticism by Justice Scalia, as well as other scholars, on the basis that it lacks a sound textual and historical basis, and leads to judicial "legislation" inappropriately interfering with State sovereignty.[20] *Amici* respectfully urge the Court to adopt Justice Scalia's textually and institutionally restrained Commerce Clause views. However, in the alternative, *amici* respectfully suggest that the Court might use this case to further clarify and refine its balancing analysis.

That analysis, embodied in *Japan Line*, *Container*, *Itel*, and *Wardair* (though that decision did not undertake a truly "dormant" analysis) considers essentially four factors: 1) Congressional action concerning legislation or international agreements related to issues raised by the tax; 2) the nature of the tax itself in the context of State taxation rights and foreign affairs; 3) to a very limited extent, the Executive's Branch's views; and 4) the Court's ability to afford an appropriate remedy if it invalidates the tax. *Amici* will now summarize their views on each of these factors.

[20] *See, e.g., Tyler Pipe Industries, Inc. v. Washington State Dept. of Revenue*, 483 U.S. 232, 259-65 (1987) (Scalia, J., concurring in part and dissenting in part). Justice Scalia recently summarized and expanded those views as respects foreign commerce in *Itel*, 113 S.Ct. at 1106-07 (1993) (Scalia, J., concurring). *See also* Breker-Cooper, *The Commerce Clause: The Case for Judicial Non-Intervention*, 69 Or. L.Rev. 895 (1990); Redish & Nugent, *The Dormant Commerce Clause and the Constitutional Balance of Federalism*, 1987 Duke L.J. 569; Eule, *Laying the Dormant Commerce Clause to Rest*, 91 Yale L.J. 425 (1982); Tushnet, *Rethinking the Dormant Commerce Clause*, 1979 Wis. L.Rev. 125. While the analysis of these scholars varies somewhat, each concludes that the Court's "negative" Commerce Clause doctrine should be considerably narrowed or abandoned.

A. Congressional Action With Respect To Legislation And International Agreements.

Given the Constitution's explicit grant to Congress of the authority to regulate foreign commerce, even in a "dormant" analysis the Court obviously should look first and most carefully to Congressional lawmaking efforts relevant to a challenged State tax. If a federal policy is expressed in Congressional action that has the force of law, with which the State tax is at odds, the Court should then invalidate the tax. Otherwise, it should be upheld. *See Itel*, 113 S.Ct. at 1104; *Container*, 463 U.S. at 196-97 (Court relies on failure of treaties and conventions to proscribe State taxes as primary support for decisions declining to invalidate taxes under negative Foreign Commerce Clause). *Cf.*, *Wardair*, 477 U.S. at 9-13 (foreign policy positions and international practices lacking the "force of law" rejected as basis for invalidating State tax). Even in *Japan Line*, the Court's most aggressive "dormant" case, the Court relied to a significant extent on its conclusion that a Container Convention between the United States and Japan "reflects a national policy" that any State property tax would "frustrate." *See also* Hellerstein Treatise, ¶8.14[5][b], at 8-147 (noting that each of the Court's "dormant" Commerce Clause State taxation decisions has looked primarily to Congressional action to determine "whether the State tax conflicts with or frustrates established Congressional policy").

As the *Wardair* discussion *supra* reveals, Congress' lawmaking conduct with respect to State worldwide unitary taxation, "by negative implication" should be considered to approve a State's right to use that taxation method, obviating the need for "dormant" Foreign Commerce Clause review. Should the Court instead reach a "dormant" analysis, that Congressional conduct makes it clear that the Court should not invalidate that taxation method, since that Congressional conduct reflects a federal policy of preserving, rather than restricting, a State's right to use that method.[21]

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[21] Barclays oddly argues that Congress' decision not to restrict State unitary taxation means that the Court should give effect to objections to such taxes by some foreign nations or the Executive, *i.e.*, that Congress has not "preempted" the Court from doing so. Barclays Br. 21-22. However, the only conclusion that can fairly be drawn from Congressional lawmaking decisions concerning proposed restrictions on unitary taxation by the States is that the Court should not use the Foreign Commerce Clause to prevent the States from using that taxation method.

B. The Nature Of The State Tax.

California's unitary corporate tax cannot be equated with the tax in *Japan Line*. The Court "deliberately emphasized in *Japan Line* the narrowness of the question presented: 'whether instrumentalities of commerce that are owned, based, and registered abroad and that are used exclusively in international commerce,'" may be subjected to property taxation by a State. *Container*, 463 at 1877, n.24. In contrast, as *Container* recognized, the tax challenged in this case merely involves California's choice of an apportionment method for attributing a part of the value of unitary business income to Barclays' business operations in California for corporate taxation purposes. However much other nations may disagree with that accounting choice, California is not thereby directly injecting itself into the conduct of foreign affairs or affronting the sovereignty of other nations.

Worldwide unitary apportionment is a tax accounting method, the choice of which may have some incidental effect on the Federal Government's conduct of foreign affairs. However, a State's choice of that well-established accounting method as best suited to its corporate taxation context, because of a policy commitment to that methodology or for administrative reasons, involves the exercise of a core right of State sovereignty, as discussed *supra*.

C. The Executive Branch's Limited Role.

Container's dicta has been viewed by some as suggesting that the Executive Branch's opposition to a particular State tax affecting foreign commerce might be sufficient to cause the Court to invalidate the tax. In fact, Barclays' argument places considerable reliance on the fact that prior Administrations provided support for its position in the California courts. As *Itel* makes clear, that reliance is misplaced.

In *Itel*, the majority opinion observed that an *amicus* brief filed by the United States supported the Court's conclusion that a State tax on lease transactions involving containers used solely in international commerce did not engender sufficient foreign policy problems to require its invalidation under the Foreign Commerce Clause. However, the Court in *Itel* stressed that the President's views were "by no means dispositive." 113 S.Ct. at 1105. Justice Scalia's concurrence and Justice Blackmun's dissent, though embracing very different views of the Foreign Commerce Clause,

also considered the President's views to be entitled to little more than persuasive weight, interestingly, for the same reason: the Commerce Clause reposes authority to regulate foreign commerce in the Congress. 113 S.Ct. at 1108, 1110.

Presidential power may be broad in a political sense, but "even for hard-nosed realists, ... the constitutional theory" of that power "cannot simply be brushed aside." Monaghan, *The Protective Power of the Presidency*, 93 Colum. L. Rev. 1, 3 (1993). The President is vested with "executive Power" by Article II, §1, of the Constitution, not independent, domestic lawmaking power.

"The President's power, if any, to issue [a domestically binding] order must stem either from an act of Congress or from the Constitution ...." *Youngstown Sheet Tube Co. v. Sawyer*, 343 U.S. 579, 585 (1952). "In the framework of our constitution, the President's power to see that the laws are faithfully executed refutes the idea that he is to be lawmaker." "And the constitution is neither silent nor equivocal about who shall make laws which the President is to execute." *Id.* at 587.

Youngstown Sheet, a Steel Seizure Case, "represents the bedrock principle of the constitutional order: except perhaps when acting pursuant to some specific constitutional power, the President has no inherent power to invade private rights; the President not only cannot act *contra legem*, he or she must point to affirmative legislative authorization when so acting." Monaghan, 93 Colum. L.Rev. at 10 (footnote omitted). That case's "premise is fully applicable to presidential conduct in foreign as well as domestic affairs: no independent, free-standing presidential law-making authority exists insofar as the rights of American citizens are concerned." *Id.* at 4 (footnotes omitted).

> Thus, whatever the range of autonomous presidential authority in the foreign affairs context, presidential authority stops well short of an independent, free-standing law-making authority. Nor has the President acquired such authority by prescription. Professor Henkin rightly observes that "[n]o one has suggested that under the President's `plenary' foreign affairs powers he can, by executive act or order, enact law directly regulating persons and property in the United States."

Id. at 49 (footnotes omitted), *quoting* L. Henkin, Foreign Affairs and the Constitution 57 (1972). These well-established principles also clearly apply to "law-making" that might limit the sovereignty of the States.

The Executive Branch lacks domestic constitutional authority to unilaterally "make laws" prohibiting taxation by the States, other than in the context of regulations or other Executive action authorized by Congress. No such authorization is present here. The only other manner in which the Executive can "make law" preempting State laws is through its role in negotiating a treaty, consented to by the Senate and ratified as law,[22] or though a valid executive agreement with a foreign nation.[23] Obviously, there is neither a treaty nor an executive agreement through which the Executive "made law" here that invalidates the California tax.

Barclays' argument with respect to this issue of Executive authority turns preemption analysis on its head. It argues that State unitary taxation intrudes into an "inherently federal area," that the Federal Government has "exclusive" authority where any "state action interferes with the conduct of foreign affairs," and that the Constitution "preempts" any such State action. Barclays Br. 41-42. To the contrary, the Constitution clearly does not, in preemption terms, "occupy the field" and nullify any State tax that might

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[22] A ratified treaty limiting State taxation would void or limit contrary State law under the express terms of the Supremacy Clause, Article VI, §2 of the Constitution.

[23] "The president can make executive agreements only in the areas where he has exclusive constitutional authority: administrative procedure, recognition of foreign sovereigns, and military affairs." S. Millet, The Constitutionality Of Executive Agreements: An Analysis Of United States v. Belmont 174 (1990). *Accord*, L. Henkin, Foreign Affairs and the Constitution 56-65 (1972) (only agreements within zones of exclusive presidential authority have effect of law); Restatement (Third) of the Law of Foreign Relations of the United States, §303(4) (1987) ("President, on his own authority, may make an international agreement dealing with any matter that falls within his independent powers under the Constitution").

Congress has primary constitutional authority for the regulation of foreign commerce and for any legislation concerning State taxation. Thus, the President certainly cannot be said to have "exclusive" or "independent" constitutional authority in that area, and serious doubts exist whether the President could constitutionally agree to restrict State income taxation schemes by executive agreement not approved as a treaty by the Senate or by Joint Resolution of Congress. *See, e.g.*, Berger, *The Presidential Monopoly of Foreign Relations*, 71 Mich. L.Rev. 1, 39 (1972) (Constitution's structure of checks and balances negates view that President may use executive agreement to address unlimited range of subjects, bypassing Senate consent process required for treaty).

implicate foreign affairs.[24] Instead, obviously, the Constitution merely gives the Congress, by virtue of its authority to regulate foreign commerce, the power to preempt such State action through legislation. *See, e.g.*, *Wardair*, 477 U.S. at 5-7.

Respect for the Executive's in foreign affairs cannot support extension to the Executive of the power to invalidate a State taxation scheme by decree or fiat on grounds of Executive "policy." That "policy" must have a basis in legislation or other form having the "force of law. Thus, as in *Itel* and *Container*, the Executive's view that a State tax does not impermissibly interfere with the conduct of foreign affairs (or a neutral view of the tax) may provide some level of comfort for a decision upholding the tax. However, to give significant weight to the Executive's views concerning a State tax would ignore the limited nature of Presidential lawmaking authority, as *Wardair* implicitly recognized. Whatever the past or present Administrations' policy positions concerning California's unitary tax might be, those positions can provide no real support for Barclays' challenge.

D. The Court's Ability To Provide A Meaningful Remedy.

Japan Line is the only case in which the Court has struck down an otherwise valid State tax on Foreign Commerce Clause grounds. The State property tax there applied to cargo containers of Japanese shipping companies, used exclusively in foreign commerce and subjected to full value taxation in Japan. The Court held that Foreign Commerce Clause principles required invalidation of the tax, particularly in light of Container Conventions eliminating all similar taxes by signatory nations. However, a meaningful factor in the decision was the available judicial remedy: since Japan taxed the containers at full value, the Court could simply declare that the

[24] Where a State's statutes or policies do not directly inject the State into matters that are within an exclusively federal province of foreign relations with specific nations, those statutes or policies are not preempted by federal authority. State action that has only "'some incidental or indirect effect in foreign countries'" does not impermissibly intrude on the foreign relations power. *Zschernig v. Miller*, 389 U.S. 429, 432 (1968). *See also De Canas v. Bica*, 424 U.S. 351, 355 (1976) (Court rejects suggestion that "dormant foreign affairs" power invalidates state legislation that indirectly affects foreign affairs). A State's choice of a tax apportionment method, whatever its incidental effect on foreign relations, is clearly not a matter within the exclusively federal province of foreign relations as to which a State is entirely preempted from entering.

containers were not subject to any property taxation by the State. *Japan Line*, 441 U.S. at 455.

This case is very different from *Japan Line* in remedial terms. If the Court were to invalidate California's unitary apportionment method, what then? The Court should inform the States in reasonable detail what apportionment method is constitutionally required to satisfy the Court's Foreign Commerce Clause concerns, though that is an essentially legislative role. Otherwise, by logical extension of the extremist "one voice" doctrine proposed by Barclays, the States would not be able to employ any method for apportioning taxes on multinational businesses that could completely avoid foreign policy "implications" -- other than perhaps the precise method used by the multinational's "home" country.[25] In that event, a State could not adopt a single, generally applicable apportionment method -- only Congress could do so. A decision by the Court invalidating the tax would thus either entirely preempt the States from devising their own schemes for multinational taxation or surrender their sovereignty in that regard to the policies of different foreign nations. Either of these results is clearly unacceptable in light of the Court's longstanding affirmance of a State's discretion to choose its apportionment method for taxing multijurisdictional unitary businesses and the Court's repeated, wise refusal to "judicially legislate" a particular apportionment method as required by the Constitution.[26]

[25] This is what Barclays and some nations are apparently demanding. The Second Supplemental Brief of Petitioner, at 2, states its position, and that of several countries, that California's change to a "water's edge" apportionment did not resolve their objections, and that "a complete solution to the problem [requires] the establishment of the arm's length principle as the only legitimate basis to tax foreign companies in any state."

[26] *See, e.g.*, *Trinova Corp. v. Michigan Dep't of Treasury*, 498 U.S. 358, 386-87 (1991) ("We have always declined to undertake the essentially legislative task of establishing a single constitutionally mandated method of taxation."). *Accord*, *Container Corp. v. Franchise Tax Bd.*, 463 U.S. 159, 171 (1983); *Moorman Mfg. Corp. v. Bair*, 437 U.S. 267, 277-80 (1978). The Court has similarly made it clear that it "cannot infer that treatment of foreign income at the federal level mandates identical treatment by the States." *Mobil Oil Corp. v. Comm'r of Taxes of Vermont*, 445 U.S. 425, 448 (1980).

E. "Negative" Foreign Commerce Clause Conclusion.

This Court has recognized that it "has little competence in determining precisely when foreign nations will be offended by particular acts, and even less competence in deciding how to balance a particular risk of retaliation against the sovereign right of the United States as a whole to let the States tax as they please." *Container*, 463 U.S. at 194. The Court should thus exercise great restraint in its Foreign Commerce Clause review of a State tax, either by adopting Justice Scalia's doctrinally restrained view of the Commerce Clause, or by balancing the interests strongly in favor of both State sovereignty and the authority of Congress to effect foreign commerce policy through law. Should the Court undertake a balancing analysis, "[l]eft to decide whether [California's] tax rests on the *Japan Line* or the *Container Corp.* side of the scale, [the Court should] have no doubt that the analysis and holding of *Container Corp.* control." *Itel*, 113 S.Ct. at 1104.

CONCLUSION

The *amici* States respectfully submit that the decisions of the California courts in these petitions should be affirmed. California's worldwide unitary apportionment tax should be upheld as constitutional under either the Court's *Wardair* "Congressional policy" analysis or its negative Foreign Commerce Clause doctrine.

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BARCLAYS BANK PLC,
Petitioner,
vs.
FRANCHISE TAX BOARD,
An Agency of the State of California,
Respondent.

COLGATE-PALMOLIVE COMPANY,
Petitioner,
vs.
FRANCHISE TAX BOARD,
An Agency of the State of California,
Respondent.

On Writ of Certiorari to the Court of Appeal of the State of California in and for the Third Appellate District

[illegible] CURIAE IN SUPPORT OF [illegible] FRANCHISE TAX BOARD BY THE [illegible] AND THE STATES OF [illegible] AND KANSAS

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QUESTION PRESENTED

Whether there is evidence of a federal policy of allowing the States to use the worldwide combined report accounting method so as to remove these cases from a Dormant Commerce Clause analysis.

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BRIEF OF AMICI CURIAE IN SUPPORT OF RESPONDENT FRANCHISE TAX BOARD BY THE STATE OF NORTH DAKOTA AND THE STATES OF HAWAII AND KANSAS

INTEREST OF AMICI CURIAE

Amici are States which compute the tax liabilities of multijurisdictional business under the "unitary business

principle." Amici have a direct interest in the question of when this Court's dormant Commerce Clause analysis applies and when actions of the Legislative and Executive Branches of the Federal Government establish that a State tax is permitted.

In 1986, this Court broke new ground in the analysis of State taxes under the Commerce Clause in its decision in *Wardair Canada, Inc. v. Florida Department of Revenue*, 477 U.S. 1 (1986). This Court applied that decision again in the 1992-93 term in *Itel Containers International Corp. v. Huddleston*, 507 U.S. ___ (1993), 122 L.Ed.2d 421. Amici have a continuing interest in the application of *Wardair* and *Itel* to State taxes.

STATEMENT PURSUANT TO RULE 37

This brief is submitted pursuant to Rule 37.3 of this Court in support of Respondent, Franchise Tax Board, State of California. Consent to the filing of this brief has not been requested from the parties because the amici filing this brief are the Attorneys General of their respective States. Rule 37.5.

SUMMARY OF ARGUMENT

This Court's decision in *Wardair Canada, Inc. v. Florida Department of Revenue*, 477 U.S. 1 (1986), establishes a framework to evaluate whether the actions of the Legislative and Executive Branches of the Federal Government permit a State tax law.

The Federal Government's actions in the circumstances of this case evidence a federal policy permitting the State tax at issue in these cases. Congress has considered the issue of worldwide combined reporting and the United States Senate

has rejected a treaty prohibition on this tax practice. In addition, the Executive Branch, by its actions, has permitted worldwide combined reporting.

California's use of worldwide combined reporting (hereinafter referred to as WWCR) should be affirmed.

ARGUMENT

IT IS THE POLICY OF THE FEDERAL GOVERNMENT, DRAWN FROM FEDERAL LAW, TO PERMIT THE STATE TAXES HERE AT ISSUE

In *Wardair Canada, Inc. v. Florida Department of Revenue*, 477 U.S. 1 (1986), the Court found the Federal Government's policy, reflected by government action and inaction, was to affirmatively permit sales taxes imposed on aviation fuel used by foreign airlines in international travel. Based upon this finding, the Court determined that a dormant Commerce Clause analysis, and specifically the "one voice" element, was inappropriate. "It would turn dormant Commerce Clause analysis entirely upside down to apply it where the Federal Government has acted, and to apply it in such a way as to *reverse* the policy that the Federal Government has elected to follow." (Court's emphasis.) 477 U.S. at 12.

Wardair provides guidance on the factors to be considered by courts when determining United States policy regarding state taxation. The Court analyzed three items: 1) the Chicago Convention on International Civil Aviation; 2) a Resolution adopted by the International Civil Aviation Organization, an organization of which the United States is a member; and 3) 70 bilateral agreements entered into by the

United States with other foreign governments.[1] With respect to these items, the Court held:

1. The Chicago Convention "precludes the imposition of local taxes on fuel only when the fuel is 'on board an aircraft . . . on arrival . . . and retained on board on leaving' . . . it does not prohibit taxation of fuel purchased." *Ibid.* The Court also stated that the provision demonstrated "awareness of the problem" and a decision to "address the problem by curtailing and limiting only some of the localities' power to tax, while implicitly preserving other aspects of that authority." *Ibid.*

2. The Resolution did not establish United States policy because even though it was the "work product of an international organization of which the United States is a member; it has not been specifically endorsed, let alone signed, entered into, agreed upon, approved, or passed by either the Executive or Legislative Branch of the Federal Government." *Id.* at 11.

3. The 70 bilateral agreements explicitly "commit[ted] the United States to refrain from imposing national taxes on aviation fuel" but in none of the "agreements has the United States agreed to deny the States the power" to tax. *Ibid.* This omission was interpreted by the Court as "a policy choice by the contracting parties, especially in light of the . . .

[1] **The bilateral agreements involved were Executive Agreements and did not qualify as treaties. Therefore, the agreements were not subject to the advice and consent of the United States Senate.**

Resolution." *Ibid.* Finally, the Court found that the "course of conduct suggests that the parties to the Agreement and those most immediately affected by it understood it to permit this sort of taxation." *Id.* at 12.

Applying *Wardair*, United States policy will be determined by considering the following factors:

1. Awareness of a problem and a decision to address the problem by curtailing some elements of authority while implicitly preserving other elements of that authority. *Id.* at 10.

2. The adoption of a policy at the national level, while excluding subnational jurisdictions from the policy. *Id.* at 11.

3. A course of conduct suggesting that the taxation involved was understood and permitted. *Id.* at 12.

Applying these evidentiary factors to Legislative and Executive Branch actions establishes that it is federal policy to permit the States to use WWCR.

A. The Actions Of Congress Are Evidence Of A Policy Of The Federal Government To Permit The State Taxes Here At Issue

1. Congressional hearings prior to the consideration of the United States/United Kingdom Tax Convention

Prior to the United States/United Kingdom Income Tax Convention, Congress studied and considered the States' use of WWCR and took no action. The Court's decision in

Northwestern States Portland Cement Company v. Minnesota and *Williams v. Stockham Valves & Fittings, Inc.*, 358 U.S. 450 (1959), prompted Congress to quickly enact Public Law 86-272. Public Law 86-272 established a minimum jurisdictional standard for the imposition of State income taxes and "initiated a comprehensive study of all matters pertaining to the taxation of income derived from interstate commerce. . . ." *State Taxation of Interstate Commerce: Report of the Special Subcommittee on State Taxation of Interstate Commerce, Committee on the Judiciary, House of Representatives*, 88th Cong., 2d Sess. (1964), Vol. 1, p. 8.

The Subcommittee, chaired by Representative Willis, conducted its study and hearings over several years. The results of this study are contained in five separate volumes and total over 2,600 pages of text and appendices. *State Income Taxation of Mercantile and Manufacturing Corporations: Hearings before the Special Subcommittee on State Taxation of Interstate Commerce of the Committee on the Judiciary House of Representatives*, 86th and 87th Cong. (1961-1962) and *State Taxation of Interstate Commerce: Report of the Special Subcommittee on State Taxation of Interstate Commerce, Committee on the Judiciary, House of Representatives*, 88th and 89th Cong., 1st and 2d Sess. (1964-1965), Vol. 1-4. Two of the issues considered by the Subcommittee are whether States should be allowed to use combined reporting and whether States should be able to consider income and activities reported as being outside of the United States. No legislation was enacted as a result of these hearings, study, or report.

Additional hearings on specific bills were held by the same Subcommittee in 1966. *Interstate Taxation Act, H.R.*

11798 and Companion Bills: Hearings before the Special Subcommittee on State Taxation of Interstate Commerce of the Committee of the Judiciary, House of Representatives, 89th Cong., 2d Sess. (1966). The reports of these hearings total over 1,800 pages. The subject matter of these bills was State tax practices with regard to interstate and foreign businesses, limitations on State use of combined reporting, and inclusion of the income and activities of foreign incorporated entities. None of these bills were enacted.

Similar hearings were held in 1973, *State Taxation of Interstate Commerce: Hearings before the Subcommittee on State Taxation of Interstate Commerce of the Committee on Finance, United States Senate*, 93rd Cong., 1st Sess. (1973).

The extensive studies undertaken by House and Senate committees demonstrate an awareness of the problems associated with the States' use of WWCR. The only action taken by Congress with respect to these concerns was the passage of Public Law 86-272. Because Congress did not adopt any other legislation, despite years of direct consideration of the "problems," Congress implicitly preserved other aspects of State tax authority.

2. Senate Consideration of the United States/United Kingdom Income Tax Convention

In 1975, the Executive Branch concluded discussions with the United Kingdom on a renegotiation of the bilateral Income Tax Convention. The revisions to the Treaty included a provision, proposed Article 9(4), which would have applied to subnational taxation. Proposed Article 9(4) would have prevented States from considering the results and activities of entities organized outside of the United States which were

owned and controlled by United Kingdom organized corporations.

In the Senate Committee on Foreign Relations Hearings on the United States/United Kingdom Tax Treaty held in July of 1977, one of the principal items of focus was the proposed Article 9(4). *Tax Treaties with the United Kingdom, the Republic of Korea, and the Republic of the Philippines: Hearings before the Senate Committee on Foreign Relations*, 96th Cong., 1st Sess. (1977). Stip. ¶ 37c, BJA-24.[2]

In June of 1978, the proposed United States/United Kingdom Tax Convention (US/UK Tax Convention) was presented to the Senate for its advice and consent. During the debate on the proposed treaty, Senator Frank Church presented a reservation, the Church reservation,[3] to the treaty which would revise the provisions of proposed Article 9(4) so that it would not apply to State taxes and would not prohibit the States from using WWCR. The Senate debated the issue of whether this reservation should be attached to the treaty with respect to Article 9(4) and whether the Senate should give its advice and consent to the Convention with Article 9(4) as proposed on June 22 and June 23, 1978. Ex. 36C, BJA-238 and Ex. 36D, BJA-311.

On June 23, 1978, the Senate voted on whether it should give its advice and consent to the Convention with Article 9(4) as proposed by the Executive Branch. The recorded vote was 49 yeas and 32 nays.[4] Ex. 36D, BJA-311 at 393-394. The

[2] References to BJA are to the Joint Appendix in *Barclays*.

[3] So named because its sponsor was Senator Frank Church of Idaho.

[4] Senator Muskie, who was present and had voted against the treaty, withdrew his vote because Senators Bentsen and Long were not present but (continued...)

Senate is required to give its advice and consent to a treaty by a vote of two-thirds of the members present. (U.S. Const., art. II, § 2, cl. 2.) The Senate had thus refused to give its advice and consent and the treaty with proposed Article 9(4) was not ratified.

On June 27, 1978, the Senate again voted on whether to give its advice and consent to the proposed United States/United Kingdom Tax Convention, this time with the Church reservation included. The Senate's advice and consent was then given by a vote of 82 yeas and 5 nays. Ex. 36D, BJA-311 at 409-410.

These actions, when analyzed in relation to the factors considered in *Wardair*, clearly evidence a federal policy to allow the States to apply WWCR.

The history of the consideration of the US/UK Tax Convention demonstrates an acute awareness of the "problem." The Senate, by declining to give its advice and consent to the treaty, dealt with one element of the "problem" by restricting the use of WWCR for national taxation and remained silent as to the other element, subnational taxation. It dealt with the entire "problem" in unequivocal terms.

The second *Wardair* factor considers adoption of a national policy without concurrent adoption of a subnational policy. Except as to discrimination, all United States Income Tax Conventions are limited in their coverage to national taxes. See for example, Article 2, "Taxes Covered." United

[4](...continued)
would have voted aye. Additional votes which were announced for absent members would have increased the final vote to 54 yeas and 34 nays. Ex. 36D, BJA-311 at 392-394.

States/United Kingdom Tax Convention, Ex. 40GG, BJA-444 at 445 et seq. In the circumstance of the US/UK Tax Convention, the question of whether subnational taxes should be accorded national treatment was presented and rejected by the U.S. Senate.

The Senate's consideration of the US/UK Tax Convention satisfies the *Wardair* factors. The Senate's course of conduct conclusively established that the Senate, and all other parties involved, understood and permitted the use of WWCR.

3. Senate Consideration of the Third Protocol to the United States/United Kingdom Tax Convention

As a result of the Senate's action in attaching the Church reservation to the proposed US/UK Tax Convention, the treaty was resubmitted to the United Kingdom. Before the treaty was approved by the United Kingdom, additional negotiations took place resulting in the Third Protocol to the Treaty. Along with other changes, the Third Protocol recognized the Church reservation. For further discussion see B.2., *infra*.

The Senate gave its advice and consent to the Third Protocol by a vote of 98 yeas and 0 nays. Ex. 36B, BJA-193 at 228.

The federal policy to allow WWCR is reinforced by the actions of the United States and the United Kingdom on the Third Protocol. The course of conduct of both countries indicates an understanding that the policy of the United States was to allow the States to use WWCR. These actions demonstrate awareness of the "problem" and the decision to curtail, at most, federal use of the WWCR method and not to curtail subnational use.

4. Congressional hearings subsequent to the negotiation of the United States/United Kingdom Tax Convention

The existence of federal policy is further established by Congressional activities contemporaneous with and subsequent to the US/UK Tax Convention. Despite numerous legislative proposals concerning WWCR, Congress refused to enact any prohibitions on the States' use of it.[5] In 1977 and 1978, while the Senate was considering the US/UK Tax Treaty, hearings were held on federal regulation of State income taxation of interstate and foreign commerce. *Interstate Taxation, S. 2173: Hearings before the Senate Committee on the Judiciary*, 95th Cong., 1st and 2d Sess. (1977-1978). Stip. ¶ 37g, BJA-24.

In 1980, the Senate Finance Committee held hearings on S. 983 and S. 1688. The primary purpose of these bills was to prohibit State use of WWCR. *State Taxation of Interstate Commerce and Worldwide Corporate Income, 1980: Hearings on S. 983 and S. 1688 Before the Subcomm. on Taxation and Debt Management Generally of the Senate Comm. on Finance*, 96th Cong., 2d Sess. (1980). Stip. ¶ 37e, BJA-24.

Again in 1986, a Subcommittee of the Senate Finance Committee held hearings on S. 1113 and S. 1974, bills which were specifically introduced to limit the States' ability to use WWCR. *Hearing before the Subcommittee on Taxation and*

[5] A list of some of the bills which have been introduced in Congress which would have affected the States' use of worldwide combined reporting is set forth at ¶ 38 of the Barclays Joint Stipulation, BJA-24. None of these bills has been enacted. A list of the hearings which have been held by various Committees of Congress is set forth at ¶ 37 of the Barclays Joint Stipulation, BJA-23.

Debt Management of the Congress on Finance on S. 1113 and S. 1974, 99th Cong., 2d Sess. (September 29, 1986). Second Stip. ¶ 37i, BJA-47.

This course of conduct indicates Congress was aware of the States' use of WWCR and acquiesced in its use.

B. The Actions Of The Executive Branch Are Evidence Of A Policy Of The Federal Government To Permit The State Taxes Here At Issue

The bilateral tax agreements establish a federal policy permitting states' use of WWCR. A consistent federal policy is also evidenced by the conduct of the Executive Branch when negotiating income tax conventions with foreign countries. These treaties show that all parties were aware of the concerns surrounding WWCR and understood that federal policy was to restrict only national, and not subnational, use of WWCR.

1. The positions of the Executive Branch in negotiating bilateral tax treaties are evidence of the policy of the United States

In 1977 the Executive Branch published a Model United States Income Tax Treaty. Ex. 45, BJA-560. It revised this document in 1981. Stip. ¶ 45, BJA-37. In the statement of taxes covered, the treaty excludes subnational taxes. In June of 1979 at the *Hearing Before the Committee on Foreign Relations of the United States Senate on Six International Tax Treaties and Protocols*, in response to a question by Senator Church, Assistant Secretary of Treasury for Tax Policy, Donald C. Lubick, explained why State taxes were not included:

> "These local U.S. taxes are not covered because it is unlikely that the United States would consent to the ratification of any treaty provision that restricted the rights of the various states to impose their own taxes." Ex. 37H, BJA-436 at 438.

In transmitting the Income Tax Convention with the Union of Soviet Socialist Republics to the Senate Foreign Relations Committee, the State Department made a similar statement regarding "Taxes Covered" in the Technical Explanation:

> "The taxes imposed by the Union Republics of the Soviet Union (comparable to states of the United States) are not covered by the Convention because, *in keeping with past U.S. policy the taxes of the state and local governments of the United States* are excluded from the scope of the Convention, except for purposes of Article X (Nondiscrimination)." (Emphasis added.) Second Stip. ¶ 60, BJA at 49, Ex. 60, p. 18.

The long debate concerning the US/UK Tax Convention further evidences that United States policy permits WWCR. In transmitting the proposed treaty to the Senate for its advice and consent, the Executive Branch noted, "A second new provision is found in paragraph 4 of Article 9 (Associated Enterprises). This provision represents the <u>first</u> <u>attempt</u> to bind State and local taxing authorities by a substantive provision of the treaty (other than non-discrimination)." (Emphasis added.) Letter of Submittal, June 8, 1976, 3 Tax Treaties (CCH) ¶10,938.

After the United States Senate had approved the proposed treaty, with the Church reservation, members of the Executive

Branch negotiated the Third Protocol to the Treaty to reflect the action of the Senate. According to Treasury, one of the changes made to the treaty by the Third Protocol related to the North Sea permanent establishment rules. The British viewed the North Sea change as a concession by the United States in exchange for British acceptance of the United States reservation on Article 9(4). Reply of Donald C. Lubick to question posed by Senator Church, Ex. 37H, BJA-436 at 437.

Other members of the international community subsequently understood that United States policy did not prohibit the States' use of WWCR. In 1978, George S. Vest, Assistant Secretary of State for European Affairs, and Francois de Laboulaye, Ambassador of France, set forth the position of their respective governments on including a treaty prohibition on the States' use of WWCR as follows:

> It is understood that the Senate of the United States has not consented to any limitation on the taxing jurisdiction of the states by treaty and that a provision which would have restricted the use of unitary apportionment in the case of United Kingdom corporations was recently rejected by the Senate. The Government of France continues to be concerned about this issue as it affects French multinationals. If an acceptable provision on this subject can be devised, the United States agrees to reopen discussions with France on this subject. Ex. 43, BJA-480 at 481-482.

In addition, Donald C. Lubick of the Department of the Treasury, in a letter dated April 22, 1980, advised Barber B. Conable, Jr. of the House of Representatives, with respect to the French Treaty:

> The unitary apportionment issue was discussed at length during the negotiation of the recent Protocol to the U.S.-French income tax Convention. The French negotiators accepted the fact that, on the basis of our experience with the U.K. treaty, the Treasury was unable to achieve ratification of a Protocol limiting unitary apportionment. Ex. 46C, BJA-568 at 570.

Further, in 1980, Allan J. MacEachen, Deputy Prime Minister and Minister of Finance of Canada, and G. William Miller, Secretary of Treasury of the United States, exchanged notes concerning Canada's desire for a limitation on the States' use of WWCR. The note of G. William Miller stated in part:

> It is understood that the Senate of the United States has not consented to any limitation on the taxing jurisdiction of the states by a treaty and that a provision which would have restricted the use of unitary apportionment in the case of the United Kingdom corporations was recently rejected by the Senate. Canada continues to be concerned about this issue as it affects Canadian multinationals. If an acceptable provision on this subject can be devised, the United States agrees to reopen discussions with Canada on this subject. Ex. 42, BJA-477 at 478.

There is no confusion in the international community and the Executive Branch about United States policy. That policy permits States to use WWCR.

2. The statements of the Executive Branch on proposed federal legislation, introduced after this Court's decision in *Container*, to prohibit State use of WWCR is evidence of the Executive's recognition of accepted United States policy

Subsequent to this Court's decision in *Container*, the Executive Branch initiated efforts in 1985 to obtain passage of federal legislation which would "[e]ffect a requirement that multinationals be taxed by states only on income derived from the territory of the United States ('the water's edge of requirement')." Ex. 36A, BJA-191. As way of explanation, President Reagan stated, "We hoped that by this time these principles would have been enacted by the various states that have unitary taxation. Since states have not universally accepted these principles, I am instructing the Secretary of the Treasury to initiate the process of crafting Federal legislation to incorporate these principles into law . . ." Ex. 36A, BJA-191.

The Executive Branch recognized: 1) the law did not require the States to forgo the use of WWCR and 2) the need to accomplish the desired change by the action of the Congress. This is not evidence of a United States policy against the States' use of WWCR, but rather evidence of an aspiration that United States policy be changed.

In September of 1986, the bill the President requested, S. 1974, came to a hearing. At the Hearing Before the Subcommittee on Taxation and Debt Management of the Senate Finance Committee on S. 1113 and S. 1974, Roger Mentz, Assistant Secretary (Tax Policy) Department of Treasury, testified as follows:

In general, S.1974 would prohibit states from levying corporate income taxes on a worldwide unitary basis, . . .

I am pleased to report that, since the introduction of the legislation, Idaho, New Hampshire, Utah and, on September 5, California, have enacted "water's edge" legislation. The Administration applauds these states' actions. These state legislative developments go a long way toward resolving the difficult unitary tax issue. Moreover, they illustrate the <u>successful</u> operation of the Federal system. (Emphasis added.) . . .

We have not, however, reached the end of the road with respect to this issue. . . . We believe, however, that such significant progress has been made that restrictive Federal legislation is not warranted at this time. Ex. 37I, BJA-440-441.

The Executive Branch was aware that the policy of the Federal Government permitted the States to use WWCR and that voluntary action was an appropriate and constitutionally permitted way to accommodate the needs of both the Federal Government and the States.

3. The Executive Branch's reservation to the model tax conventions of the Organization for Economic Cooperation and Development (OECD) is evidence of the policy of the United States to permit the States to use WWCR

In *Wardair*, this Court considered the significance of the adoption by an international organization of a model agreement which would have treated national and subnational taxes in an identical manner. This Court held that the action of the international agency was of no evidentiary value in

determining whether there was a policy of the United States against the State tax at issue in *Wardair* because the United States had taken no action to endorse, adopt, or enact the policy.

In 1963, and again in 1977, the Committee of Fiscal Affairs to the Council of the OECD published a Model Double Tax Convention on Income and On Capital. Ex. 44, BJA-484-559. The Executive Branch of the United States announced its reservation to that portion of the Model Treaty which made it applicable to subnational taxes. Ex. 44, BJA-484 at 501. This expressed reservation is evidence of federal law as it existed.

Under the *Wardair* analysis, the OECD Model Treaty cannot establish a United States policy prohibiting the State tax at issue because the United States did not endorse, adopt, or enact the policy. To the contrary, the Executive Branch's announcement of a reservation to the OECD Model Treaty evidences the United States policy not to restrict subnational taxation and, therefore, to permit the States to use WWCR.

CONCLUSION

The actions of both the Executive Branch and the Legislative Branch of the Federal Government provide clear and convincing evidence that the United States' policy is to permit the States to use WWCR. In many respects, the evidence present in these cases is more compelling than that relied upon by this Court in *Wardair*.

Use of WWCR by California and the other States is constitutionally permissible and the judgments of the California courts should be affirmed.

Dated: January 19, 1994

Respectfully submitted,

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No. 92-1384

IN THE
SUPREME COURT OF THE UNITED STATES
OCTOBER TERM, 1993

BARCLAYS BANK PLC,

Petitioner,

v.

FRANCHISE TAX BOARD, an Agency
of the State of California,

Respondent.

ON WRIT OF CERTIORARI TO THE
COURT OF APPEAL OF THE STATE OF CALIFORNIA
IN AND FOR THE THIRD APPELLATE DISTRICT

BRIEF OF WASHINGTON LEGAL FOUNDATION AND ALLIED EDUCATIONAL FOUNDATION AS *AMICI CURIAE* IN SUPPORT OF PETITIONER

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Date: December 16, 1993

QUESTION PRESENTED

Amici will address the following question:

Whether California's application of worldwide combined reporting to determine the taxable income of domestic corporations with foreign parents, or foreign corporations with either foreign parents or foreign subsidiaries, is unconstitutional under the Foreign Commerce Clause.

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IN THE
SUPREME COURT OF THE UNITED STATES
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No. 92-1384

BARCLAYS BANK PLC,

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v.

FRANCHISE TAX BOARD, an Agency of the State of California,

Respondent.

On Writ of Certiorari to the Court of Appeal of the State of California in and for the Third Appellate District

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BRIEF OF WASHINGTON LEGAL FOUNDATION AND ALLIED EDUCATIONAL FOUNDATION AS *AMICI CURIAE* IN SUPPORT OF PETITIONER

INTERESTS OF *AMICI CURIAE*

The Washington Legal Foundation is a non-profit public interest law and policy center with more than 100,000 members and supporters nationwide. While WLF engages in litigation and the administrative process in a variety of areas, WLF devotes a substantial portion of its resources to promoting economic liberty, free enterprise principles, and a limited and accountable government. To that end, WLF has appeared before this Court as well as other state and federal courts in cases that involved impermissible attempts to usurp the role of the federal government in the conduct of foreign affairs or where

foreign affairs considerations were involved in the resolution of the case. *See, e.g., Equal Employment Opportunity Comm'n v. Arabian American Oil Co.*, 111 S. Ct. 1227 (1991); *Perpich v. U.S. Dep't of Defense*, 110 S. Ct. 2418 (1990). In particular, WLF has appeared before this Court in cases in which the conduct of one or more States threatens the free flow of foreign commerce. *See, e.g., Kraft General Foods, Inc. v. Iowa Dep't of Revenue and Finance*, 112 S. Ct. 2365 (1992).

The Allied Educational Foundation (AEF) is a non-profit charitable and educational foundation based in Englewood, New Jersey. Founded in 1964, AEF is dedicated to promoting education in diverse areas of study, such as law and public policy, and has appeared as *amicus curiae* in the federal courts on a number of occasions.

WLF and AEF believe that the economic well-being of this country depends on the unrestricted flow of commerce, both interstate and across our nation's borders. They are extremely concerned that the income apportionment method employed by the State of California for purposes of income tax assessment will lead foreign countries to adopt retaliatory tax measures that will inevitably restrict the flow of foreign commerce.

Amici submit this brief in support of Petitioner with the written consent of both parties. The written consents are on file with the Clerk of the Court.

STATEMENT OF THE CASE

In the interests of judicial economy, *amici* hereby adopt by reference the Statement of the Case set forth in Petitioner's brief.

In brief, this case involves the 1977 California income tax liability of two corporate affiliates of the Barclays Group, a United Kingdom banking group of over 220 corporations doing business in some 60 nations. The two affiliates, Barclays Bank International Limited (now

Barclays Bank PLC) and Barclays Bank of California, were the only two corporations within the banking group that conducted business in California.[1]

Petitioner seeks a refund of taxes paid as a result of assessments (totalling in excess of $150,000) levied by Respondent Franchise Tax Board (the "Board"). The Board computed its assessment based on application of California's "worldwide combined reporting" ("WWCR") method of income allocation. That method entails computing the *worldwide* income of any multinational corporate group found to comprise a "unitary enterprise" and then apportioning a portion of that income to California based on a formula that purports to take into account the percentage of the enterprise's activities with a California situs.

The effect of the WWCR method is that Petitioner must pay a California income tax based on profits earned by all 220 corporations within the Barclays Group -- even though only two of those corporations conducted any business (and earned any profits) in California in 1977. The WWCR method differs from the tax-assessment method employed by the United States government and every other country in the world. They employ the "arm's length method," which treats each corporation as "an independent entity dealing at arm's length with its affiliated corporations, and subject to taxation only by the jurisdictions in which it operates and only for the income it realizes on its own books." *Container Corporation of America v. Franchise Tax Board*, 463 U.S. 159, 185 (1983).

Claiming that the correct method upon which to compute its income tax was the arm's length method, Petitioner filed suit in California Superior Court for a tax

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[1] Only one other corporation in the banking group did any business in the United States, and it conducted none of its business in California.

refund. Petitioner claimed that California's use of the WWCR method violated the Foreign Commerce Clause and the Due Process Clause of the U.S. Constitution, at least when applied to taxpayers that are members of a foreign-owned and controlled unitary group.

Both the Superior Court and the California Court of Appeal found that the Board's application of the WWCR method to foreign-owned unitary groups violated the Foreign Commerce Clause because it "impair[ed] federal uniformity in an area where federal uniformity is essential" and "prevent[ed] the Federal Government from 'speaking with one voice when regulating commercial relations with foreign governments.'" *Japan Line, Ltd. v. County of Los Angeles*, 441 U.S. 434, 448, 451 (1979). *See* Petition Appendix ("P.A.") A and B. The California Supreme Court reversed, finding no Foreign Commerce Clause violation based on the "one voice" rationale. P.A. C-38. It remanded the case to the Court of Appeal to decide two issues not previously decided: whether California's use of the WWCR method violated the Foreign Commerce Clause because it discriminated against foreign corporations, and whether it violated the Due Process Clause. P.A. C-39. The Court of Appeal ruled against Petitioner on both of those issues (P.A. "D"), and the California Supreme Court declined further review.

This Court granted a petition for writ of certiorari on November 1, 1993. Among the questions presented by the petition, *amici* address only the first: whether California's use of the WWCR method to determine the taxable income of domestic corporations with foreign parents, or foreign corporations with either foreign parents or foreign subsidiaries, is unconstitutional under the Foreign Commerce Clause.

SUMMARY OF ARGUMENT

In order to avoid having to undertake a dormant Foreign Commerce Clause analysis in this case, the California Supreme Court discerned a "clear federal

directive" that states should be permitted to employ the WWCR method in determining the tax liability of multinational corporate groups. That finding is not supported by any of the evidence adduced by the California court; indeed, the same evidence was also available to this Court when it decided *Container Corp. of America v. Franchise Tax Board*, 463 U.S. 159 (1983), and this Court did not deem that evidence sufficient to establish any clear federal directive. The California Supreme Court's reliance on *Wardair Canada, Inc. v. Florida Dept. of Revenue*, 477 U.S. 1 (1986) is misplaced; that case did not in any way alter the Court's basic approach to dormant Foreign Commerce Clause jurisprudence. The California court's refusal to consider the position of the executive branch when seeking to determine the existence of a "clear federal directive" was also error.

California's use of the WWCR method clearly violates the dormant Foreign Commerce Clause, because it prevents the federal government from speaking with one voice in international trade. The threat to the free flow of foreign commerce is readily apparent: numerous foreign governments have made clear that they are offended by the California tax system, one foreign government has already adopted retaliatory legislation, and more such legislation can be expected unless the Court reverses the decision of the California Supreme Court.

ARGUMENT

I. THE FEDERAL GOVERNMENT HAS NOT AFFIRMATIVELY DECIDED TO PERMIT WWCR

A. Controlling Legal Principles

Article I, § 8, cl. 3 of the U.S. Constitution reserves to Congress the power to regulate commerce with foreign nations and among the States. This Clause, "by its own force created an area of trade free from interference by the

States" and "even without implementing legislation by Congress is a limitation upon the power of the States." *Boston Stock Exchange v. State Tax Comm'n*, 429 U.S. 318, 328 (1977). That portion of Commerce Clause jurisprudence involving limitation on State powers even in the absence of Congressional action is generally referred to as the "dormant" Commerce Clause.

The test for determining whether state taxing schemes violate the Commerce Clause is well established. A state taxing scheme is considered fair -- and thus does not impermissibly burden interstate commerce -- if it "is applied to an activity with a substantial nexus with the taxing State, is fairly apportioned, does not discriminate against interstate commerce, and is fairly related to the services provided by the State." *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274 (1977). When the state tax involves foreign commerce and is challenged under the dormant Foreign Commerce Clause, two additional questions must be addressed to determine the constitutionality of the tax:

> [F]irst, whether the tax, notwithstanding apportionment, creates a substantial risk of international multiple taxation, and second, whether the tax prevents the Federal Government from "speaking with one voice when regulating commercial relations with foreign governments." If a state tax contravenes either of these precepts, it is unconstitutional under the Commerce Clause.

Japan Line, 441 U.S. at 451.

Amici submit that the Board's use of the WWCR method violates the second of the two *Japan Line* tests: it prevents the federal government from speaking with one voice when regulating commercial relations with foreign governments. Because this Foreign Commerce Clause violation is so clear, *amici* believe it is unnecessary to reach any of the other arguments raised by Petitioner.

The Court expanded upon the meaning of the "one voice" test in *Container Corp.*[2] Where a state tax is at variance with federal policy, it violates the "one voice" standard if it "implicates foreign policy issues" -- such as creating a threat of "offending our foreign trading partners and leading them to retaliate against the nation as a whole." *Container Corp.*, 463 U.S. at 194. But if a state tax does not implicate foreign affairs but rather merely "has foreign resonances," then it violates the Foreign Commerce Clause only if it "violates a clear federal directive." *Id.* The Court recognized that cases decided under the "clear federal directive" standard were "essentially a species of pre-emption analysis." *Id.*

B. Federal Approval of Commerce Clause Violations Is Not To Be Inferred in Absence of Unambiguous Declaration

In upholding the Board's application of the WWCR method to foreign-controlled corporate groups, the California Supreme Court seized upon the "clear federal directive" language to avoid altogether a dormant Foreign Commerce Clause analysis. The California Supreme Court stated that whenever there is a "clear federal directive" that a state tax scheme is either permissible or

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[2] In *Container Corp.*, the Court upheld the Board's use of the WWCR method with respect to domestic-controlled corporate groups. However, it explicitly left open the question raised in this case: "the constitutionality of [WWCR] apportionment with respect to state taxation of domestic corporations with foreign parents or foreign corporations with either foreign parents or foreign subsidiaries." *Container Corp.*, 463 U.S. at 189 n.26. The Court added,

> We recognize that the fact that the legal incidence of a tax falls on a corporation whose formal corporate domicile is domestic might be less significant in the case of a domestic corporation that was owned by foreign interests. We need not decide here whether such a case would require us to alter our analysis.

Id. at 195 n.32.

impermissible, that directive controls and no dormant Foreign Commerce Clause analysis is necessary. P.A. C-25, 26. Relying on this Court's decision in *Wardair Canada, Inc. v. Florida Department of Revenue*, 477 U.S. 1 (1986), the California court went on to discern a Congressional intent that States should be free to employ the WWCR method in computing corporate income tax liability, even when dealing with foreign-controlled corporate groups. P.A. C-28 to C-37. Accordingly, the court found no Foreign Commerce Clause violation. P.A. C-38.

The California Supreme Court was undoubtedly correct in declaring that the ultimate decision regarding whether a state taxing scheme violates the Foreign Commerce Clause rests with Congress. No matter how discriminatory a state taxing scheme may be and no matter how serious may be its foreign policy implications, the scheme does not violate the Commerce Clause if Congress declares that no violation exists. If it so chooses, Congress is free to invite foreign retaliation by sanctioning state taxing scheme that other countries find highly objectionable.

But such action by Congress is sufficiently unusual that this Court has been highly reluctant to infer such Congressional intent. A federal statute will not be read as approving state conduct that (in the absence of congressional approval) would constitute a dormant Commerce Clause violation unless Congress has "manifest[ed] its *unambiguous* intent" to so approve. *Wyoming v. Oklahoma*, 112 S. Ct. 789, 802 (1992). Congress has manifested no such intent in this case. The California court's reliance on *Wardair* in support of its finding of such a congressional intent is misplaced.

C. *Wardair* Inferred Congressional Approval Based on Congressional Action, Not Inaction

In order to fully comprehend why the California Supreme Court's heavy reliance on *Wardair* was misplaced, a detailed review of that decision is warranted.

In that case, Florida's sales taxation of all fuel purchased in Florida was challenged by a Canadian airline insofar as it authorized assessment of a tax on fuel used by foreign airlines engaged exclusively in foreign commerce. The airline argued that Congress had intended to preclude state taxation of foreign airline fuel when it adopted the Federal Aviation Act; and that (for purposes of dormant Foreign Commerce Clause analysis) the United States had manifested its "policy of tax exemption for the instrumentalities of international air traffic" by: (1) becoming a party to the Chicago Convention on International Civil Aviation (a 1944 international convention signed by 157 nations that created an "international aspiration" to "eliminate all impediments to foreign air travel"); (2) its membership in the International Civil Aviation Organization (ICAO), which adopted a 1966 resolution calling for foreign airlines to be exempt from all State sales taxation; and (3) its entry into more than 70 bilateral agreements dealing with international aviation, in which the United States committed itself not to impose a national tax on aviation fuel. *Wardair*, 477 U.S. at 9-11.

The Court rejected the airline's claim that Florida's tax flunked *Japan Line*'s "one voice" test. The Court held that the dormant Foreign Commerce Clause was not even implicated by the case because, it said, Congress had used its "voice" to speak up affirmatively in favor of the right of states to tax fuel sales to foreign airlines. *Id.* at 9-12. The Court said:

> Foreign Commerce Clause analysis requires that a court ask whether a state tax "prevents the Federal Government from 'speaking with one

> voice when regulating commercial relations with foreign governments.'" But we never suggested in [*Japan Line*] or any other [case] that the Foreign Commerce Clause *insists* that the Federal Government speak with any particular voice.

Wardair, 477 U.S. at 13 (quoting *Japan Line*, 441 U.S. at 451).

In discerning federal approval of the Florida's right to impose its sales tax on foreign airlines, the Court looked to the following evidence: (1) § 1113 of the Federal Aviation Act, 49 U.S.C. § 1513, directly addressed the issue of "State taxation of air commerce" and included "sales or use taxes on the sale of goods or services" among those taxes that were permissible; (2) Article 24(a) of the Chicago Convention, 61 Stat. 1180, by its terms precluded the imposition of local taxes on fuel only when the fuel is "on board an aircraft . . . on arrival . . . and retained on board on leaving" and did not preclude local taxation of fuel purchased in that locality; (3) the federal government, although a member of the ICAO, never signed or even endorsed the ICAO resolution, and thus the resolution's condemnation of local fuel taxes could not be deemed U.S. policy; (4) *after* the Chicago Convention came into force, the United States became a party to more than 70 bilateral aviation agreements, and while the agreements explicitly committed the U.S. to refrain from imposing national taxes on aviation fuel, in none did the U.S. agree to bar the States from imposing such taxes; (5) the U.S.-Canadian Agreement, signed eight years after the ICAO resolution was adopted and thus at a time when negotiators would have been aware of the resolution's disapproval of local sales taxes on fuel, limited the tax exemption to be afforded to foreign air carriers to "national duties and charges"; and (6) throughout the time that the U.S.-Canadian agreement had been in effect, some American States and some Canadian Provinces had imposed local sales taxes on aviation fuel purchased by the other country's airlines. *Id.* at 6-7, 9-12.

Wardair can thus be seen as a generally unremarkable effort by the Court to discern congressional intent based on an analysis of congressional *action*. The evidence relied on by the Court included *affirmative* adoption of the Federal Aviation Act, *affirmative* adoption of the Chicago Convention, and *affirmative* adoption of the 70 bilateral aviation agreements. The Federal Aviation Act *explicitly permitted* state sales taxation of fuel purchases; even standing alone, that piece of evidence would probably have been sufficient to demonstrate congressional intent. With regard to the Chicago Convention and the bilateral aviation agreements, the Court quite reasonably concluded that since (during the course of taking these affirmative steps) the federal government could reasonably have been expected to have said so if it did not intend to permit state taxation, its failure to say so is an indication that it did intend to permit state taxation.

Accordingly, the California Supreme Court's reliance on *Wardair* to discern congressional approval of California's application of the WWCR method to foreign-controlled corporate groups is untenable. The evidence cited by the California court in support of its finding of congressional approval of WWCR is not even remotely similar to the evidence present in *Wardair*. The evidence cited by the California court consists solely of congressional *inaction*. There is a world of difference between *Wardair*'s suggestion that the "negative implications" of affirmative congressional action are relevant to a determination that Congress consented to a state law (*Wardair*, 477 U.S. at 10, 12) and the California Supreme Court's assertion that congressional consent can be inferred from the "negative implications" of congressional *inaction*.

Indeed, this Court has repeatedly warned against drawing any inferences from Congress's failure to act. *Brecht v. Abrahamson*, 113 S. Ct. 1710, 1719 (1993); *Schneidewind v. ANR Pipeline Co.*, 485 U.S. 293, 306 (1988); *American Trucking Assns., Inc. v. Atchison, T. & S.F.R. Co.*, 387 U.S. 397, 416-418 (1967).

Yet, the California court's conclusions were based largely on such inferences. The items of inaction relied on by the California court were:

(1) Failure of the Senate to adopt by 2/3 vote a U.S.-U.K. tax treaty that included a provision barring State use of the WWCR method (P.A. C-27);

(2) Failure to include bans on state use of the WWCR method in various bilateral tax treaties (*id.*);

(3) The absence of restrictions on state taxation in "Friendship, Commerce and Navigation" treaties to which the U.S. was a party (*id.*); and

(4) Abandonment of executive branch efforts to obtain restrictions on state taxation through bilateral treaties, following rejection of the U.S.-U.K. tax treaty (*id.* at C-28);

(5) The failure of Congress to adopt legislation restricting state use of the WWCR method (*id.* at C-30 to C-31).

The first and fifth item relied on by the California Supreme Court (failure of Congress to adopt legislation and the U.S.-U.K. Treaty) are the most clearly flawed; as noted above, congressional inaction is simply not a guide to congressional intent. That is particularly true in the case of the U.S.-U.K. tax treaty, which actually commanded majority support in the Senate. Moreover, among the minority of Senators who opposed the treaty, there is no way of knowing whether they did so because they wanted to permit States to use the WWCR method; it is equally plausible that they simply opposed effecting a restriction on state taxing powers by means of a treaty ratification rather than by means of direct legislation.

The second and third items, while bearing superficial resemblance to items considered by the Court in *Wardair*, are of little evidentiary value. The treaties in question are

totally silent regarding proper reporting requirements at the subnational level. This contrasts sharply with the evidence in *Wardair*, where (for example) the Chicago Convention directly addressed the imposition of local sales taxes and banned such imposition only when the fuel is "on board an aircraft . . . on arrival . . . and retained on board on leaving." *Wardair*, 477 U.S. at 10. Moreover, as the California Court of Appeal noted, most of these treaties were adopted prior to WWCR's use becoming widespread -- and thus it is highly likely that the negotiators gave little thought to addressing state taxation issues. This contrast sharply with the situation in *Wardair*, where virtually all negotiations took place against the backdrop of the Chicago Convention's explicit acquiescence to imposition of state sales tax on all fuel purchases in the state.

The evidence of executive branch abandonment of efforts to adopt treaties containing bans on state use of the WWCR method actually cuts against the California court's position. As the California Supreme Court acknowledges, the executive branch has had a decades-long policy of asserting that state use of the WWCR method violates the dormant Foreign Commerce Clause. The executive branch's alleged abandonment of treaty efforts is fully consistent with its belief that such treaties are unnecessary (because use of the WWCR method is prohibited by the Foreign Commerce Clause). It is hardly evidence that the executive branch has acquiesced to state use of the WWCR method.[3]

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[3] The California Supreme Court's reliance on this executive branch evidence is particularly ironic, in light of its refusal to consider the longstanding executive branch opposition to WWCR in determining whether there was a "clear federal directive." *See* P.A. C-37 n.22 ("Although we accept the Justice Department's argument that the views of the executive branch on the international effect of state taxation practices are entitled to 'great weight' under a foreign dormant commerce clause analysis (cf. *Container*, *supra*, 463 U.S. at p. 196), our conclusion that such an analysis is not triggered here forecloses resort to those views."). That refusal was clear improper. While the overriding consideration in determining whether the federal government

(continued...)

Finally, there is simply no support for the California Supreme Court's assertion that *Wardair* represents a departure from prior Supreme Court analysis of dormant Foreign Commerce Clause issues. Certainly, *Wardair* itself makes no such claim. Subsequent decisions from this Court have discussed dormant Foreign Commerce Clause issues without giving any indication that *Wardair* marked a departure from prior case law. *See, e.g., Kraft General Foods, Inc. v. Iowa Department of Revenue and Finance*, 112 S Ct. 2365 (1992). In the absence of such a departure, the findings of *Container Corp.* are still good law -- and those findings including a finding that the federal government had not provided a clear directive one way or the other regarding the propriety of state adoption of the WWCR method. The California Supreme Court's subsequent determination that Congress has directed that states should be free to adopt WWCR is untenabie, given that the evidence relied on by the California court in arriving at that determination was also available to this Court in the *Container Corp.* case.

In sum, the California Supreme Court erred in determining that Congress has provided a "clear directive" that States should be permitted to adopt the WWCR

[3] (...continued)
has provided a "clear directive" on a Commerce Clause issue is whether Congress has acted, the role of the executive branch is far from irrelevant in ascertaining that directive. Congressional silence in the face of executive branch assertion that state taxation is unconstitutional is certainly of some significance. If the views of the executive branch were irrelevant, *Container Corp.* most likely would have used the term "clear congressional directive" rather than the term "clear federal directive." *Container Corp.*, 463 U.S. at 194. Moreover, the Court in *Wardair* found it significant, in finding federal acquiescence in state sales taxation of aviation fuel, that the executive branch had neither endorsed nor signed the ICAO Resolution which condemned such taxation. *Wardair*, 477 U.S. at 11. If executive branch action were irrelevant in ascertaining a "clear federal directive," the Court would not have deemed the executive branch's conduct worthy of mention.

method. Certainly, nothing in *Wardair* supports that decision.

II. RESPONDENT'S TAXATION SYSTEM PREVENTS THE FEDERAL GOVERNMENT FROM SPEAKING WITH ONE VOICE IN INTERNATIONAL TRADE

In the absence of clear directive from Congress on the issue, the appropriate course is to resort to traditional dormant Foreign Commerce Clause analysis in determining the propriety of the Board's use of WWCR.

Under *Container Corp.*, the only relevant questions are: (1) whether the California system is "at variance with federal policy"; and (2) whether the California system implicates foreign policy issues which must be left to the federal government. *Container Corp.*, 463 U.S. at 194. Both questions can only be answered "yes."

First, we do not understand even the Board to contest that California's use of the WWCR method is at variance with federal policy. The United States and every national government in the world employs the "arm's length" method. In its *amicus* brief filed in this case with the California Supreme Court, the United States said:

> It is the expressed policy of the United States that the separate accounting or "arm's length" method is the appropriate method of allocating income among commonly controlled multinational corporations. . . This view has been adopted in the United States Internal Revenue Code (26 U.S.C., Section 482), and is embodied in virtually all bilateral tax treaties that have been entered into by the United States. . . The "arm's length" is the international norm. . . Application by states of the worldwide combined unitary method of taxation conflicts directly with this federal policy and international standard.

P.A. H-10 to H-12.[4]

The serious foreign policy implications of continued state use of the WWCR method are self-evident. The Court recognized in *Container Corp.* that "[t]he most obvious foreign policy implication of a state tax is the threat it might pose of offending our foreign trading partners and leading them to retaliate against the Nation as a whole." *Container Corp.*, 463 U.S. at 194. The briefs filed to date in this case by numerous foreign countries is ample evidence that our foreign trading partners are deeply offended by California's continued use of the WWCR method.[5]

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[4] *Amici* do not know what position the current administration will take in the *amicus* brief it files in this case. *Amici* do know, however, that California's use of WWCR conflicts with a strong federal policy that has existed for the past two decades and that undeniably was in place during the tax year in dispute in this case -- 1977. Moreover, as this Court made clear in *Container Corp.*, the position taken by the United States in an *amicus* brief "is by no means dispositive." *Container Corp.* 463 U.S. at 195-196. Indeed, the Court in *Wardair* found that the federal government had affirmatively sanctioned state sales taxation of aviation fuel, despite claims to the contrary contained in an *amicus* brief by the United States.

[5] Whether our trading partners are justified in taking offense is largely beside the point -- since the mere existence of that offense is sufficient to disrupt foreign commerce, a result that is ultimately to no one's advantage. In any event, *amici* believe that foreign governments are fully justified in taking offense. First, as *Container Corp.* recognized, the WWCR method inevitably leads to double taxation. California is justifiably seen by foreign countries as attempting to secure more than its fair share of corporate profits: California is a jurisdiction where wage rates, property values, and sales prices are relatively high, almost ensuring that the WWCR method will redound to California's benefit. *See Container Corp.*, 463 U.S. at 202 (Powell, J., dissenting). Second, although every country in the world employs the arm's length method, California's insistence on using the WWCR method forces every major corporation in the world to keep books in conformity with California's demands. Third, while application of WWCR to domestic multinational corporations is not a major concern to most foreign countries, all foreign countries are understandably protective toward their own multinationals.

Moreover, retaliation has already begun. The United Kingdom has adopted retaliatory legislation which (although not currently being enforced) one can reasonably expect will be enforced unless the California Supreme Court's decision is reversed. The Court need not await guidance from the federal government to determine that such retaliation will harm the entire American economy.

In sum, California should not be permitted to retain a income taxation system that may benefit one state but that ultimately hurts the rest of the American economy as a result of retaliation by those who are inevitably angered by the WWCR system.

CONCLUSION

Amici curiae Washington Legal Foundation and Allied Educational Foundation respectfully request that the judgment below be reversed.

Respectfully submitted,

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No. 92-1384

IN THE

Supreme Court of the United States

OCTOBER TERM, 1993

BARCLAYS BANK PLC,
Petitioner,
v.
FRANCHISE TAX BOARD,
AN AGENCY OF THE STATE OF CALIFORNIA,
Respondent.

On Writ of Certiorari to the Court of Appeal of the State of California in and for the Third Appellate District

BRIEF OF THE GOVERNMENT OF THE UNITED KINGDOM AS AMICUS CURIAE IN SUPPORT OF PETITIONER

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BRIEF OF THE GOVERNMENT OF THE UNITED KINGDOM AS AMICUS CURIAE IN SUPPORT OF PETITIONER

INTEREST OF AMICUS CURIAE

The United Kingdom is one of the major trading partners of the United States. It has for many years been the largest direct investor in the United States, with an estimated $110 billion in such investments on an historical cost basis. Almost one thousand U.K.-owned multinational groups do business through approximately three thousand subsidiaries in virtually all the states of the Union. In order to encourage still greater investment and trade which

would redound to the benefit of both nations, the United Kingdom and the United States have sought consistently to apply the principles of the arm's length-separate accounting method in determining the proper international division of income for tax purposes. Both Nations believe application of this method protects their respective fiscs while preventing inappropriate double taxation of their taxpayers. It also creates a mechanism for resolving disputes and, more generally, provides the certainty in the taxation of international commerce that is sought by international investors.

The State of California, in the year in question, imposed mandatory worldwide unitary taxation—a system completely inconsistent with the arm's length-separate accounting method—on all corporations doing business in California. Barclays Bank of California ("Barcal"), a California corporation, and Barclays Bank International Limited ("BBI"), a U.K. company, subsidiaries of petitioner's predecessor, both did business in California. They were required to pay tax on their California income calculated with reference to the worldwide profits of the entire Barclays group—over 220 corporations conducting more than 98 percent of their business outside the United States. This resulted in substantially higher tax than would have arisen under application of the arm's length-separate accounting method.

The United Kingdom has a significant and legitimate interest in protecting U.K. multinational groups from damage caused by the imposition of worldwide unitary tax. It is greatly concerned that if mandatory worldwide unitary taxation of the type imposed by California were to be upheld, its multinationals would be adversely affected, the imposition of worldwide unitary taxation by the states would multiply, and, in seeking to protect its legitimate interests and those of its multinationals, its relations with the United States as a whole would be severely impaired. The Government of the United Kingdom believes that this case provides the opportunity for this Court definitively to hold unconstitutional the imposition of mandatory worldwide unitary taxation by any State on companies that are part of a foreign-owned multinational group.

The Government of the United Kingdom submits this brief *amicus curiae* in support of petitioner.[1]

SUMMARY OF ARGUMENT

The Government of the United Kingdom believes that the instant case requires application of this Court's Dormant Foreign Commerce Clause analysis. Despite the assertions of the FTB and the holding of the California Supreme Court, the Government of the United Kingdom believes that Congress has not authorized the States of the Union to impose mandatory worldwide unitary taxation on foreign owned-groups. In particular, nothing in the ratification process of the U.K.-U.S. Tax Treaty can be construed as approval—either affirmatively or by "negative implication."

The California worldwide unitary tax fails both of the tests specifically fashioned for Dormant Foreign Commerce Clause analysis in *Japan Line, Ltd.* v. *County of Los Angeles*, 441 U.S. 434 (1979): substantial risk of international multiple taxation and interference with the ability of the Federal Government to speak with one voice when regulating foreign commerce.

There can be no doubt that California's imposition of worldwide unitary taxation creates for foreign-owned groups a substantial risk of international double taxation in every case. While it may not always produce actual double taxation (although it did in the instant case), the risk is inevitable. The constitutional significance of the "mere *risk*" of double taxation was specifically reserved

[1] Petitioner and Respondent have consented to the filing of this brief *amicus curiae* in letters filed with the Clerk of this Court.

by this Court in *Japan Line*, and should be resolved now. The adverse impact of this risk on inbound foreign investment is manifest. Furthermore, as the dissent in *Container Corp.* v. *Franchise Tax Board*, 463 U.S. 159 (1983) pointed out, there is a reasonable alternative to worldwide unitary taxation, namely, "water's edge."

Mandatory worldwide unitary taxation also interferes with the Federal Government's ability to "speak with one voice" in regulating the foreign commerce of the United States. The most compelling manifestation of this interference has been the hostile reaction of foreign nations, and the United Kingdom in particular, with possible adverse consequences for this Nation as a whole. The United Kingdom enacted retaliatory legislation in 1985, and in 1993 came to the very brink of activating it. The justification for any such retaliation is clear—worldwide unitary taxation has an extraterritorial reach that places all foreign-owned multinationals at risk of double taxation, thereby requiring their residence countries either to allow them to suffer that burden or provide relief to the detriment of their own fiscs.

The Government of the United Kingdom also believes that California's worldwide unitary taxation fails the first of the *Complete Auto Transit, Inc.* v. *Brady*, 430 U.S. 274 (1977) tests, namely, "substantial nexus." In *Quill Corp.* v. *North Dakota*, 112 S.Ct. 1904 (1992), this Court established that the Commerce Clause requires a more significant level of contact than the "minimal" Due Process nexus requirements considered by this Court in *Container*. Because of the heavy burden a worldwide unitary tax imposes on foreign commerce, the requisite level of contact between the taxing state and the activities it would tax simply cannot be found with respect to those members of foreign-owned unitary groups that operate in foreign jurisdictions and have no connection with the United States other than through their corporate affiliation.

ARGUMENT

I. Congress Has Not Authorized States to Impose Mandatory Worldwide Unitary Taxation on Foreign-Owned Groups

A. General

1. Regulation of Foreign Commerce

The Government of the United Kingdom regards the issue presented by the instant case as posing the most fundamental of constitutional questions in the areas of federal-state relations and foreign relations. Under the U.S. Constitution, Congress is vested with the power "To regulate Commerce with foreign Nations. . . ." Art. I, § 8, cl. 3. Taxation is, of course, a form of regulation. Consequently, on the face of it, there would seem to be no power in the States to tax any aspect of foreign commerce in the absence of Congressional authorization to do so.

Even in the absence of such authorization, however, the States and their political subdivisions have undertaken to impose certain forms of taxation on foreign commerce. As a result, this Court has been called upon to determine the constitutionality of a variety of such taxes—Los Angeles County's ad valorem property tax on containers (struck down) in *Japan Line, Ltd.* v. *County of Los Angeles*, 441 U.S. 434 (1979); Florida's sales tax on aviation fuel (upheld) in *Wardair Canada, Inc.* v. *Florida Dep't of Revenue*, 477 U.S. 1 (1986); Iowa's income tax on foreign subsidiary dividends (struck down) in *Kraft Gen. Foods, Inc.* v. *Iowa Dep't of Revenue & Fin.*, 112 S. Ct. 2365 (1992); and Tennessee's sales tax on container leases (upheld) in *Itel Containers Int'l Corp.* v. *Huddleston*, 113 S.Ct. 1095 (1993). The most directly pertinent decision, of course, is *Container Corp.* v. *Franchise Tax Board*, 463 U.S. 159 (1983), in which this Court, by a 5-3 majority, upheld California's mandatory worldwide unitary income tax, but only in re-

lation to a domestic-owned group of corporations that included foreign subsidiaries.

All of these cases make it clear that absent an expression of Congressional intent that a particular state tax on foreign commerce is permissible, this Court will undertake to test the validity of the tax under the so-called Dormant Commerce Clause analysis that has been adhered to since the mid-nineteenth century.

2. Dormant Commerce Clause Analysis

Under Dormant Commerce Clause analysis, as applied to the Foreign Commerce Clause, this Court will strike down a tax if it fails any one of six different tests. The first four tests were originally set forth in *Complete Auto Transit, Inc.* v. *Brady*, 430 U.S. 274 (1977), a case involving the Interstate Commerce Clause. They were extended to the Foreign Commerce Clause in *Japan Line, supra*. They require that (1) there must be "substantial nexus" between the activities being taxed and the taxing state, (2) the tax must be fairly apportioned, (3) the tax must not be discriminatory against foreign commerce, and (4) the tax must be fairly related to the services received from the taxing jurisdiction.[2] *Japan Line*, 441 U.S. at 444-446. The remaining two Foreign Commerce Clause tests, set forth by this Court for the first time in *Japan Line*, are that (5) the tax must not create a substantial risk of international multiple taxation, and (6) the tax must not prevent the Federal Government from speaking with one voice when regulating commercial relations with foreign governments. *Id.* at 451.

The Government of the United Kingdom is aware of no affirmative legislation enacted by Congress that authorizes the imposition by individual States of worldwide unitary taxation on foreign-owned multinational groups. Neverthe-

[2] The tests set out in (2), (3), and (4) are not considered in this brief *amicus curiae*.

less, the California Supreme Court, while not disagreeing with that proposition, concluded by process of "negative implication" that Congress had in fact authorized the States to utilize that method of taxation. As a result, the California Supreme Court concluded that there was no need to engage in Dormant Foreign Commerce Clause analysis.

The Government of the United Kingdom believes that the analysis of the California Supreme Court is subject to "serious question" (*see* Brief for the United States as *Amicus Curiae*, filed October 7, 1993, at 7). It wishes specifically to address one of the points on which the court below relied in finding its "negative implication." That point involves the developments relating to the approval and ratification of the United Kingdom-United States Double Taxation Treaty (the "U.K.-U.S. Treaty") in the late 1970's.

B. Ratification of the U.K.-U.S. Treaty

In both the decision of the California Supreme Court and the brief of respondent Franchise Tax Board ("FTB") in opposition to certiorari, much has been made of the reservation by the U.S. Senate to a portion of Article 9(4) of the U.K.-U.S. Treaty and the subsequent approval of the revised treaty by the U.K. Parliament.[3]

The Government of the United Kingdom does not now, and did not either at the time of the reservation by the U.S. Senate or at the time of ultimate approval by the

[3] As originally drafted, Article 9(4) would have expressly precluded the States from imposing worldwide unitary taxation on members of a U.K.-owned multinational group.

A majority of the Senate, but not the necessary two-thirds, approved the Treaty with Article 9(4) in its original form. A reservation to remove the prohibition on the States from the scope of Article 9(4) failed on a separate vote. After parliamentary maneuvering, however, the Senate then ratified the Treaty with the reservation attached.

U.K. Parliament, believe that the action of the Senate constituted "Federal acquiescence" in California's system of worldwide unitary taxation. Furthermore, the Government of the United Kingdom, in the strongest possible terms, wishes to disabuse this Court of any impression that the approval of the U.K.-U.S. Treaty by the U.K. Parliament in any particular constituted acceptance by the United Kingdom of California's imposition of worldwide unitary taxation on U.K.-owned groups.

1. The Senate Reservation

After reading this Court's decision in *Wardair* as establishing "a kind of protocol for identifying those kinds of governmental silences that give rise to 'negative implications' supporting an inference of Federal acquiescence in the state tax case under challenge," App. at C-34[4] the California Supreme Court completely misconstrued the significance of the Senate's reservation.

As described by that court, the reservation was "the most explicit example of a persistent Congressional refusal to enact curbs on the states' use of worldwide formula apportionment . . . ." App. at C-23. It is clear from all the differing opinions expressed both in the Senate debate and in committee, however, that there was no single Congressional policy underlying the reservation. Moreover, only one House of Congress considered the treaty in any event.

During the debates on the treaty in June 1978, three distinct views on Article 9(4) emerged. There were those who would vote for it, those who would vote against it because they thought the states should have the unfettered right to tax foreign-owned multinationals, and those who would vote against it because they did not believe that a

[4] All references to pages A-___, B-___, and C-___ are to pages in the Appendices to Petition for a Writ of Certiorari filed in the instant case. All references to exhibits are to those numbered in the Joint Stipulation of Facts on pages A-36 to A-73.

single bilateral tax treaty to be placed only before the Senate was the proper vehicle for considering a measure that should be acted on by both Houses as part of a uniform policy to be applied to all nations.

The importance attached to this third factor was attested to throughout the debates. The chief opponent of the original Article 9(4), Senator Church, stated:

> If accepted by the Senate, this provision could serve as a precedent for fashioning internal tax policy via agreements with foreign governments—a method that circumvents the tax writing committees of both the House and the Senate. This is the first time the treaty power has been used in such a manner, and, I believe, it represents an unwarranted extension of that power which we will come to regret.

124 Cong. Rec. 16892 (1978).

Similarly, Senator Stevens stated: "I suggest that a tax treaty is not the proper nor desirable medium for the exercise of this [Federal] power." (*Id.* at 18427.)

If this were not clear enough, it is given added force by the 1979 Senate Foreign Relations Committee report on the Third Protocol to the U.K.-U.S. Treaty (not cited by the California Supreme Court), which gave formal effect to the Senate reservation. The Foreign Relations Committee stated that:

> Even some supporters of Article 9(4), while not questioning the propriety of the Article, indicated their preference for Congressional consideration through the legislative process of the issue. The Foreign Relations Committee notes that Section 303 of S. 983, the Interstate Taxation bill introduced by Senator Mathias, would accomplish for all nations what Article 9(4) of the U.S.-U.K. Tax Treaty sought to accomplish for the U.K.

> The Committee urges the tax-writing Committees of the Congress—the Finance and the Ways & Means Committee—to hold hearings in the very near future on S. 983 in order to permit all sides of the issue to have their views known for the record. In addition, such legislation will give the Congress, which has the responsibility to resolve on the federal level inconsistent state taxation policies, the opportunity to take a position on the merits of the case.

Exhibit 37b.

From this, it seems clear that the Senate Foreign Relations Committee—the Committee responsible for the ratification process—in no way considered the Senate votes on Article 9(4) as themselves somehow having been intended to authorize state use of worldwide unitary taxation.

Yet, from the Senate's action on this one bilateral treaty—not 70 bilateral agreements and a 157-nation international agreement as considered in *Wardair*—and from the many motives expressed by Senators rather than one consistent theme, the California Supreme Court somehow discerned what it believed to be clear congressional intent. The Government of the United Kingdom does not see how the equivocal actions of the Senate with respect to a single treaty (where a majority of the Senators actually voted in favor of the original Article 9(4)) could be held to constitute Congressional approval of the states' use of worldwide unitary taxation.

2. Approval by the U.K. Parliament

The California Supreme Court also suggested (citing *Wardair*, 477 U.S. at 11) that the U.K.'s ratification of the treaty "must be understood as representing a policy

choice by the contracting parties."[5] App. at C-30. Furthermore, in its brief in opposition to certiorari, the FTB stated "The government of the United Kingdom, while regretting the defeat of the prohibition as preliminarily negotiated in 1975, recognized that the US/UK Treaty as finally negotiated and ratified was a 'fair and balanced agreement.' " FTB Opp. at 6.

The Government of the United Kingdom wishes firmly to reject the impression conveyed by the California Supreme Court and the FTB regarding its intentions in approving the Treaty. The FTB extracted the quoted phrase out of context from a demarche of March 25, 1980 sent to the State Department upon the exchange of instruments of ratification bringing the Treaty into force. The penultimate paragraph of the demarche directly addressed the unitary tax issue:

> Her Majesty's Government has recognized, in ratifying this Convention with the approval of the United Kingdom Parliament, and in its acceptance of the United States Senate reservation against Article 9(4) of the Convention, the dif-

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[5] The court went on to buttress its argument by contending that the "international business community" had somehow been on "notice" as to worldwide unitary taxation for the last seventy years. App. at C-32. The court's reliance on the 1924 decision in *Bass, Ratcliff & Gretton, Ltd.* v. *State Tax Comm'n*, 266 U.S. 271 (1924), in that regard is misplaced: that case involved only formulary apportionment of a single entity (combined reporting on a worldwide basis was not yet invented) and it also preceded both the adoption of the international arm's length standard and this Court's modern Commerce Clause jurisprudence.

Moreover, *Bass, Ratcliff* was not an income tax case. It involved a franchise tax imposed for the privilege of doing business in New York. The measure of the tax was net income for the prior year, computed on an apportionment basis. The taxpayer, a U.K. corporation, manufactured ale in England and sold it in New York and elsewhere. Even though the taxpayer suffered a loss on its New York operations in the prior year, this Court upheld application of the tax for the privilege of doing business in the current year.

ficult issues raised within the United States in seeking to limit State taxing powers through the double taxation conventions of the United States. It has also recognized the importance of the Convention in its many other aspects for the two Governments and for the business and investment communities on each side. *It must be emphasized however that the acceptance of the Senate reservation in no way implies approval of the unitary basis* and it is the urgent request of Her Majesty's Government for the reasons given in this Note that the Government of the United States should use its best endeavours to eliminate the international application of the unitary basis of taxation. (emphasis added.)

Exhibit 32c.

For the reasons set forth above, as well as those set forth by petitioner in its brief, the Government of the United Kingdom strongly urges this Court to reject the analysis of the court below and acknowledge that the instant case presents a question for decision under the Dormant Foreign Commerce Clause.

II. Issues Under the Dormant Foreign Commerce Clause

Moving first to the two tests that this Court has fashioned peculiarly for Dormant Foreign Commerce Clause analysis, the Government of the United Kingdom believes that California's worldwide unitary tax fails both tests. As will be shown below, California's taxing scheme "creates a substantial risk of international multiple taxation" *Japan Line*, 441 U.S. at 451, and, in this case, actual double taxation. It also interferes with the ability of the Federal Government to speak with one voice in its regulation of commercial relations with foreign governments.

A. Substantial Risk of International Multiple Taxation

Because there was in fact inevitable actual double taxation in *Japan Line*, this Court specifically reserved the issue whether the "mere *risk*" of such taxation would result in unconstitutionality.

> Because California's tax in this case creates multiple taxation in fact, we have no occasion here to decide under what circumstances the mere *risk* of multiple taxation would invalidate a state tax, or whether this risk would be evaluated differently in foreign, as opposed to interstate, commerce.

Japan Line, 441 U.S. at 452 n.17 (emphasis in original) (citations omitted).

Since actual double taxation of income may not be inevitable under worldwide unitary taxation, the Government of the United Kingdom believes that the instant case presents the proper occasion for this Court to resolve the issue left open in *Japan Line*.

In *Container*, this Court declined a similar opportunity. The majority apparently believed that *Japan Line* required a showing of actual double taxation in every instance before the California unitary tax could be found to violate the "multiple taxation" test. In any event, the majority identified two inquiries to be undertaken in applying the multiple taxation test:

> Although double taxation in the foreign commerce context deserves to receive close scrutiny, that scrutiny must take into account the context in which the double taxation takes place and the alternatives reasonably available to the taxing state.

Container, 463 U.S. at 189.

The "context" on which the majority focused in *Container* was the fact that an income tax, rather than a property tax, was involved. The difficulties identified in dividing income among taxing jurisdictions apparently caused the majority to be unsympathetic to the taxpayer's double taxation claim. The "alternatives" which the majority said were available to California were either to refrain from taxing income altogether or to adopt the arm's length method of taxation. Neither alternative was found acceptable as applied to a domestic-owned group.

1. Context Revisited

The tax here involved is also an income tax—indeed, the same tax that was involved in *Container*. However, the group bearing the burden of the tax here is foreign-owned rather than domestic-owned as in *Container*. As will be shown, foreign-owned groups considering doing business in California are *inevitably* exposed to a substantial risk of international double taxation under the California taxing scheme. For the reasons noted below, that fact should be sufficient to render California's tax unconstitutional when applied to foreign-owned groups.

California's system of worldwide combined reporting requires a taxpayer in a foreign-owned group to include in its California tax base the entire worldwide income earned by the group as a whole. That is the essence of the unitary business concept—flows of value within the group justify treating it as if it were essentially a single entity. Yet all but the U.S. portion of that income would have been subject to tax in other countries under the arm's length-separate accounting method that is the international norm. Requiring the non-U.S. portion of the income, as so computed, to be included in the California tax base thus guarantees not only that it will be exposed to a second tax, but to a second tax computed on a different and inconsistent basis (i.e., formulary apportionment).

There is, in short, a conceptual clash between the arm's length method and worldwide unitary taxation—the former being fact-specific and applied on a transaction-by-transaction basis, the latter being entirely formulaic and computed by reference to global figures accumulated on an annual basis. There is simply no harmony between the two systems. Whether actual double taxation in fact will result in any given case where the two systems are applied becomes a matter of pure chance.[6] It is hard to imagine a clearer example of a tax giving rise to a "substantial risk of international multiple taxation" than a worldwide unitary tax imposed on a tax base that includes income that has also been subject to tax in another jurisdiction under the arm's length method.

While the same substantial risk of double taxation theoretically exists in the case of a domestic-owned group with foreign subsidiaries, it does not necessarily lead to a comparable indication of constitutional infirmity. In the context of business conducted within the United States, i.e., interstate commerce, this Court has allowed the States a certain amount of flexibility in applying apportionment formulae to the income of a unitary business. *Moorman Mfg. Co.* v. *Bair*, 437 U.S. 267 (1978) (Iowa single sales factor formula upheld even though neighboring Illinois used

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[6] If the apportionment formula produces a result that is less than the U.S. portion of the group's worldwide income, computed on an arm's length basis, no double taxation of income will occur. If the formula produces a greater result, double taxation of some portion of the group's non-U.S. source income will occur.

It is no answer to suggest that California is only taxing that portion of the group's income fairly attributable to it, not a portion of worldwide income *per se*. If the business is unitary, all of the income goes into a single pool. The rationale for apportionment is that all members of the group have contributed to the total amount in the pool, and the states where they operate may each tax some portion of the whole. That is why under unitary taxation even a loss company may find itself paying tax on apportioned income. California cannot have it both ways.

three-factor formula). Possible overlaps in formulae among the States may in fact result in some domestic double taxation. Yet this Court has concluded that because it does not sit as the legislature of last resort, it will uphold any domestic apportionment formula that is reasonable in application, notwithstanding possible overlaps and resulting double taxation.

Since *Container* involved a domestic parent company doing business in California, the fact that the income of its foreign subsidiaries was included in California's tax base for apportionment purposes and that the formula applied by California produced actual double taxation in that case (463 U.S. at 187 n. 22) essentially reflected an extension of the principles set down in *Moorman*. *See Container*, citing *Moorman*, 463 U.S. at 192-193. The possibility of an overlap of this sort is simply one of the accepted hazards under which domestic-owned businesses know they must operate. The principles of *Moorman* have never been applied to foreign-owned groups, however.

The reason why a substantial risk of double taxation is of greater constitutional significance in the case of foreign-owned, as contrasted with domestic-owned, groups is the adverse impact that the risk has on inbound international investment. The international commitment to use of the arm's length-separate accounting method for dividing income is designed to provide assurances to international investors that they should not suffer inappropriate double taxation on the profits from their investments. If a State is allowed to apply worldwide unitary taxation to international income, no such assurances can be given. That, in turn, plainly serves to discourage international investment in unitary states and, as a result, adversely affects the United States as a whole.

Presumably for these very reasons, the Secretary of State, the Honorable George P. Shultz, wrote to the Governors of California and other unitary tax States in 1986 to express the foreign policy concerns of the United States in relation to the imposition of worldwide unitary taxation and its effect on international investment.

> In an environment in which separate accounting is the federal policy and the generally accepted international rule, state taxation on a worldwide unitary basis creates a clear risk of double taxation. . . . This risk of double taxation may distort investment decisions, thereby reducing the overall flow of investment into the United States.

Exhibit 46h.

While actual double taxation may not be inevitable under California's taxing scheme (although petitioner did suffer such double taxation here), that fact should not relieve the California tax of its infirmity. The question reserved in *Japan Line* was whether the "mere *risk*" of multiple taxation was sufficient to invalidate a state tax, particularly in the case of foreign commerce. That question should now be answered in the affirmative. Any state tax that inevitably exposes foreign-owned groups to a substantial risk of multiple taxation directly interferes with inbound investment decisions. As a result, it places an undue burden on foreign commerce and should be invalidated under the Foreign Commerce Clause.

2. Alternative Taxing Methods

The majority in *Container* appears to have believed that there were only two alternatives to worldwide unitary taxation that were open to the State of California: the arm's length method or no tax at all. 463 U.S. at 190. As the minority pointed out, however, there is a third alternative: the so-called "water's edge" method. *Id.* at 198-199 n.1.

The "water's edge" method is designed to apply unitary taxation and formulary apportionment only to income arising within the United States. Under a water's edge approach, therefore, domestic source income could continue

to be apportioned among the states in time-honored fashion. But the tax could also be applied on a basis consistent with the Federal treatment of international income because the tax base would not include income determined under the arm's length method to have had its source in other countries.

The water's edge method is clearly an alternative "reasonably available to the taxing state". California recently adopted a new elective variation of the water's edge method in the amendatory legislation it enacted in October 1993. The availability of the water's edge alternative permits the conclusion that the inevitable *risk* of double taxation should itself be sufficient to invalidate worldwide unitary taxation when imposed on foreign-owned groups.

B. Speaking with One Voice

1. In General

Under the Constitution, the Federal Government is charged with responsibility for the policies of the United States regarding all matters involving foreign commerce. That is one proposition on which the Framers were most insistent when they agreed upon the distribution of powers between the Federal and State governments. *See Japan Line*, 441 U.S. at 449; *Michelin Tire Corp.* v. *Wages*, 423 U.S. 276, 283-286 (1976).

The States, therefore, may not conduct their affairs in a manner that interferes with the foreign policy of the Nation. The question presented here is whether California's imposition of worldwide unitary taxation on foreign-owned groups impermissibly interferes with the Federal Government's conduct of its commercial relations with foreign nations.

In both *Japan Line* and *Container*, one of the principal concerns of this Court in considering the "one voice" test was whether the nature and scope of the state tax in question created a significant prospect of retaliation against

the United States as a whole by the affected foreign government(s). A state tax that could provoke such retaliation would obviously represent a serious interference with the conduct of foreign commercial relations. There can be no clearer illustration of how an inappropriate state taxing scheme can spark the type of foreign government reaction that jeopardizes the conduct of foreign commercial relations than the response to California's imposition of its worldwide unitary tax on foreign-owned groups.

2. Retaliation and the United Kingdom

The Government of the United Kingdom wishes to reiterate to this Court that its acceptance of the U.K.-U.S. Treaty with the Article 9(4) reservation did not constitute acceptance of the California system of worldwide unitary taxation. It also did not quiet the strong demands for action on the issue in the U.K. Parliament that ultimately resulted in the enactment of specific retaliatory legislation.

The foundation for that legislation can be traced to a December 17, 1981 letter from the then Chancellor of the Exchequer, the Rt. Hon. Sir Geoffrey Howe, Q.C., M.P., to the U.S. Secretary of the Treasury, the Honorable Donald T. Regan. (The letter was appended to the Administration's brief *amicus curiae* filed in this Court in support of the petitioner in *Chicago Bridge & Iron Co.* v. *Caterpillar Tractor Co.*, 454 U.S. 1029 (1981), *appeal dismissed*, 463 U.S. 1220 (1983)). In that letter, the Chancellor stated that worldwide unitary taxation:

> . . . introduces an undesirably asymmetric element into the tax relationship between our two countries, since the unitary basis of taxation with worldwide combined reporting is not used by the U.K. at any level of government. This imbalance is causing increasing concern, not only on the part of British companies which have made rep-

resentations about it, but in Parliament where Questions have been asked.[7]

Following the 1983 decision of this Court in *Container*, President Reagan formed a Working Group on Worldwide Unitary Taxation that was charged with studying the issue and making recommendations for action. The Working Group recommended a water's edge solution, but no concrete action resulted.

Concerned about the progress being made on the subject in the United States, Parliament proceeded to enact legislation in 1985 that gave the United Kingdom power to retaliate against national and subnational authorities that imposed worldwide unitary taxation on U.K.-owned companies. The legislation authorized, in respect of any U.S. corporation having a "qualifying presence" in a "unitary state," the withdrawal of the right to claim the partial tax credit given by the U.K. under the U.K.-U.S. Treaty in respect of dividends paid by a U.K. subsidiary. (The legislation is now contained in sections 812-815 of the Income and Corporation Taxes Act 1988.)

After Parliament's passage of the retaliatory legislation, California enacted its own legislation in 1986. For the first time, it provided a water's edge election for multinational groups, beginning in 1988. The change was generally considered unacceptable to the multinational community because of its conditionality, including the imposition of a substantial fee and the retention by the State of a right to impose unitary tax notwithstanding the election. Nevertheless, the fact that California had taken some steps, coupled with the commencement of the instant litigation in the California courts as a test case for foreign-owned

[7] Brief *Amicus Curiae* of the United States, in *Chicago Bridge & Iron Co.* v. *Caterpillar Tractor Co.*, App. at 3a, Docket No. 81-349. "Questions" in Parliament are the traditional means whereby M.P.'s express concern to the Government.

groups, caused the Government of the United Kingdom to defer implementation of its retaliatory legislation at that time.

Eventually, faced with the prospect of no immediate solution to the problem, the then Chancellor of the Exchequer, the Rt. Hon. Norman Lamont, M.P., announced in May 1993 that the Government of the United Kingdom would have to take retaliatory measures in respect of California's worldwide unitary tax if the matter were not satisfactorily resolved by the end of the year.

> . . . I have informed [the U.S. Secretary of the Treasury] that the Government will have to take retaliatory measures in relation to United States based companies if there is not a satisfactory resolution of the problem of the internationally-opposed unitary tax on foreign-owned companies in California by the end of this year.[8]

Following this announcement, the U.K. Board of Inland Revenue notified 900 major U.S. corporations with U.K. subsidiaries of the various retaliatory options available to it under the 1985 U.K. legislation.

In response to the 1993 developments, the California legislature adopted certain further modifications to its water's edge election, effective in 1994. This action prompted the Chancellor of the Exchequer, the Rt. Hon. Kenneth Clarke, Q.C., M.P., to inform the U.S. Secretary of the Treasury, the Honorable Lloyd Bentsen, that the United Kingdom would defer the implementation of any retaliatory measures in 1993 and would retaliate only if it became clear that the new legislation was being applied

[8] Statement of the Chancellor of the Exchequer, the Rt. Hon. Norman Lamont, M.P., May 13, 1993.

in a way that damaged U.K.-owned companies.[9] This position was expanded upon in the Chancellor's public statement of September 15, 1993:

> While the legislation in California is a significant step forward, on its own it does not provide a complete solution to the unitary tax problem. For a complete solution it will be necessary to have the internationally accepted arm's length principle endorsed, on a permanent basis, as the only valid method of taxing foreign companies in any State. Success for the Barclays case in the Supreme Court would achieve this. The Government will continue strongly to support Barclays' case. I hope it will succeed. If it does not, the UK will have to retain its retaliatory powers in reserve as a barrier against the possibility that States might damage UK owned companies by the imposition of unitary taxation at some time in the future.[10]

In *Container*, the majority concluded that because the legal incidence of the California tax fell on a domestic corporation (albeit one with foreign subsidiaries), foreign governments would not be justified in engaging in significant retaliation. 463 U.S. at 194-195. In so concluding, the majority expressly acknowledged that the result might well be different if the tax fell on a domestic corporation that was owned by foreign interests. *Id.* at 195 n.32. Here, the legal incidence of the tax fell on Barcal (a domestic subsidiary) and BBI (a U.K. subsidiary doing business in California) when both were owned by foreign interests (i.e.,

[9] Letter of Chancellor of the Exchequer, the Rt. Hon. Kenneth Clarke, Q.C., M.P. to U.S. Secretary of the Treasury, the Honorable Lloyd Bentsen, September 14, 1993.

[10] Statement of the Chancellor of the Exchequer, the Rt. Hon. Kenneth Clarke, Q.C., M.P., September 15, 1993.

petitioner's predecessor). The circumstances are thus quite different than in *Container*.

There can be no doubt about the overwhelmingly hostile reaction in the U.K. (and elsewhere) to California's worldwide unitary taxation as imposed on foreign-owned groups. There can also be no doubt that the tax has had an extremely adverse effect upon the foreign commercial relations of the United States. For its own part, the Government of the United Kingdom considers that it has not before come so close to retaliating economically against another sovereign nation over an issue of taxation, and certainly has never previously come so close to economic retaliation against a sovereign nation over the taxation activities of a political subdivision thereof.

3. Reaction of Other Governments

That California's taxing scheme interferes with the ability of the Federal Government to conduct its foreign commercial relations indisputable. If further proof is needed, it can be found in the reaction to California's tax by many of the other major trading partners of the United States. In the last fifteen years, more than twenty diplomatic notes and other formal communications have been sent to the State Department objecting to worldwide unitary taxation. Those demarches have spelled out the attitude of numerous foreign governments to the California tax. In addition, twenty OECD nations wishing to make their views even more clearly known to this Court have joined in the filing of a separate brief *amici curiae* in support of petitioner in the instant case. The Government of the United Kingdom knows of no other state tax that has ever engendered such a powerful reaction from foreign governments.

Given the extraterritorial reach of the California tax and the fact that both the legal incidence and the economic burden of the tax fall on foreign interests in the instant case, coupled with the inevitable exposure of such foreign-

owned groups to the substantial risk of double taxation, actual retaliation by a foreign government would clearly be justifiable even under *Container*'s standards. Indeed, the residence country of a foreign-owned group can find itself facing an unacceptable choice: either to allow its multinational companies to be double taxed under worldwide unitary taxation or to forego part of its own tax revenue by providing relief through tax credits (or otherwise) for a second tax that is imposed under a system incompatible with its own. The circumstances here present—in sharp contrast to those in *Container*—clearly justify retaliation and, therefore, require a holding of unconstitutionality under the Foreign Commerce Clause.

C. Substantial Nexus

The remaining Dormant Commerce Clause test which the Government of the United Kingdom wishes to address in this brief *amicus curiae* is the nexus test. It requires that the tax in question must be applied "to activities with a substantial nexus with the taxing State." *Japan Line*, 411 U.S. at 444.

Prior to this Court's decision in *Quill* v. *North Dakota*, 112 S.Ct. 1904 (1992), it had been assumed that some form of "minimum contact" between the activity and the taxing state satisfied both the Due Process and Commerce Clause requirements for "nexus." In *Container*, for example, this Court considered the "nexus" issue solely in those terms. 463 U.S. at 165-166.

Quill involved the question whether companies selling goods into a state by mail order could be required to collect the state's use tax. This Court held that they could not unless they satisfied the more stringent Commerce Clause "nexus" requirement by maintaining a physical presence in the state. In its decision in *Quill*, this Court made it clear that the "nexus" standard under the Commerce Clause is a higher standard than under the Due Process Clause because the Commerce Clause is concerned with

the extent of the actual burden being imposed on commerce by the tax in question. Due Process, by contrast, is concerned only with whether the taxpayer was sufficiently connected with the state to be a proper subject of taxation.

As was stated in *Quill*, the "substantial nexus" test imposed under the Commerce Clause serves to "*limit the reach* of State taxing authority so as to ensure that State taxation does not unduly burden interstate commerce." *Quill*, 112 S.Ct. at 1913 (emphasis added). (While *Quill* was an interstate commerce case, the same principles underlie the "substantial nexus" test in the foreign commerce area. *Japan Line*, 441 U.S. at 444-445.)

It seems clear from *Quill* that the extent of nexus required under the Commerce Clause is influenced by the nature of the burden imposed on commerce. Since foreign commerce is involved here, the issue would seem to be particularly sensitive because of the various ways in which a state tax might interfere with the conduct by the United States of its foreign commercial relations.

Under worldwide unitary taxation, the California tax base consists of the combined net incomes of all the corporations in the Barclays group, i.e., more than 220 separate corporations doing over 98 percent of their business outside the United States. App. at B-26. The question presented under the Foreign Commerce Clause is whether there is sufficient nexus between California and the activities of those corporations in the countries where they operate to justify including the income derived from those activities in the California tax base. The answer must be in the negative for at least two reasons.

First, there is no indication of any meaningful contact between the State of California and the activities of the various corporations in the Barclays group that operate in the 59 countries other than the United States. To find

Commerce Clause nexus in the absence of any meaningful contact is clearly inconsistent with *Quill*.

Second, the extraterritorial reach of California's tax has placed a severe burden on foreign commerce. Not only does it generally interfere with inbound international investment decisions because of the inevitable exposure of such investment to double taxation, but it also has created an international reaction of major proportions. (The United Kingdom, the largest foreign direct investor in the United States, reached the brink of economic retaliation before California amended its taxing scheme in 1993.) In the view of the Government of the United Kingdom, California should be denied the ability to include the worldwide income of foreign-owned groups in its tax base because of the extraordinarily heavy burden its unitary tax has placed on foreign commerce.[11]

The only possible basis upon which a claim of sufficient nexus could rest here would derive from the fact that, under California law, the Barclays group conducts a "unitary business." The theory underlying the unitary method of taxation is that certain intangible "flows of value" within the unitary group serve to link the various members together as if they were essentially a single entity. That linkage may have caused the trial court below to conclude

[11] This analysis need not apply with respect to domestic-owned groups with foreign subsidiaries. In those situations, it can be assumed that all the income earned by the group will be remitted to, or realized by, the domestic parent at some point in time. The burden placed on commerce by worldwide unitary taxation is thus much less severe in such a case, because it is only a matter of timing as to when the state would be able to reach—and tax—the income in any event.

The same cannot be said of foreign-owned groups with domestic subsidiaries. The income of such a group will flow away from the unitary tax state, not toward it. Under those circumstances, therefore, the state is seeking to tax income which it would not be able to reach either then or at a later time.

that California had the requisite nexus with every member of the Barclays group.[12]

While such intangible flows of value may be the rationale for treating a multinational group as a unitary business, their rather speculative "subtle and largely unquantifiable" nature (*Container*, 463 U.S. at 164-165) make them too insubstantial to provide the requisite linkage for Commerce Clause nexus. *Quill* suggests that something far more tangible is required.

* * * *

In the view of the Government of the United Kingdom, California's system of mandatory worldwide unitary taxation as applied to foreign-owned groups goes beyond what is contemplated by the U.S. Constitution because of (1) the inevitable exposure of foreign-owned groups to the substantial risk of double taxation, (2) the manner in which the tax interferes with inbound investment decisions and thereby impacts on the conduct of U.S. foreign commercial relations, and (3) the extraterritorial reach that sweeps into the tax base income earned from international activities with which the state has insufficient contact to provide substantial nexus.

[12] That is not entirely clear, however. The trial court actually appeared to accept the nexus analysis adopted in *Container*, which, as noted, was a "minimum connection" analysis. *See* App. at A-30 - A-31.

CONCLUSION

For all the foregoing reasons, the decisions of the courts below should be reversed and California's mandatory worldwide unitary taxing scheme should be held unconstitutional.

Respectfully submitted,

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Nos. 92-1384 and 92-1839 (Consolidated)

IN THE
Supreme Court of the United States

OCTOBER TERM, 1993

BARCLAYS BANK PLC,
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v.

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Respondent.

On Writ of Certiorari to the Court of Appeal of the State of California in and for the Third Appellate District

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BRIEF OF THE COMMITTEE ON STATE TAXATION AS *AMICUS CURIAE* IN SUPPORT OF PETITIONERS

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BRIEF OF THE COMMITTEE ON STATE TAXATION AS *AMICUS CURIAE* IN SUPPORT OF PETITIONERS

INTRODUCTORY STATEMENT

This brief is submitted by the Committee on State Taxation as *amicus curiae* in support of the petitioner in the above-captioned matter, as well as in the matter of *Colgate-Palmolive Co. v. Franchise Tax Board*, Docket No. 92-1839, which matter has been consolidated for hearing purposes with *Barclays Bank PLC v. Franchise Tax Board*. Written consents of the petitioners and respondents have been obtained and filed with the Clerk of the Court.

INTEREST OF *AMICUS CURIAE*

The Committee on State Taxation ("COST") is a non-profit association that was organized in 1969 as an advisory committee to the Council of State Chambers of

Commerce. COST, which was separately incorporated on January 1, 1992, has a membership of over 400 major multistate corporations engaged in interstate and international business. COST's principal objective is to preserve and promote equitable and nondiscriminatory state and local taxation of multijurisdictional business entities.

Virtually all of COST's members are engaged in business in the State of California, and many of these corporations are members of unitary groups—both foreign-parent groups and domestic-parent groups with foreign subsidiaries—that have been subject to California's worldwide reporting method. Moreover, many COST member companies were directly and adversely affected by the threatened and real retaliatory measures imposed by foreign nations in response to California's use of a taxing method that encroached upon their sovereignty. Therefore, COST has an interest in the instant case.

SUMMARY OF ARGUMENT

Every nation in the world, including the United States, has chosen to assert its taxing jurisdiction over nondomiciliary corporations by reference to arm's length/separate accounting, a method which respects the sovereignty of other nations wherein multinational corporations may conduct business giving rise to taxable income. The United States sanctions this method of taxation of foreign commerce because (i) it cannot give offense to our trading partners, but instead fosters mutually beneficial commercial and political relations; (ii) the taxing method's prerequisite that transactions cross national borders ensures that jurisdiction to tax is unimpeachable; and (iii) it has been the basis of this nation's treaty representations to foreign nations concerning the type and degree of administrative burdens and tax liabilities that the United States will impose on foreign commerce.

The foreign Commerce Clause was originally drafted and has since been interpreted by this Court to provide special protection to domestic business from any foreign retaliation that results when a state ventures on its own to tax foreign commerce in a way that, being inconsistent with federal policy in this regard, prevents the federal government from "speaking with one voice" when regulating foreign commerce. In this case, California has chosen to impugn the United States' sanctioned method of taxing commerce by imposing forced worldwide combined reporting and its concomitant administrative and compliance burdens upon many unitary foreign affiliates without any direct contact with California. This jurisdictional affront has resulted in the very retaliatory threats and measures by foreign nations that the Framers feared in a system without uniform federal regulation of foreign commerce, but that the Framers intended the foreign Commerce Clause to rectify. California's use of forced worldwide combination cannot withstand scrutiny under the foreign Commerce Clause and is therefore unconstitutional.

The practical significance of this issue to domestic business is further illustrated by the fact that several states in addition to California have adopted various forms of forced worldwide combination. These states have tools available to them to impose tax on any income of a corporation that arises from activities conducted in their jurisdictions but that has been shifted to an inappropriate taxing jurisdiction; therefore such encroachments on the sovereignty of other nations are both unnecessary and unjustifiable, by reference to the foreign Commerce Clause.

ARGUMENT

I. THE HISTORY AND PURPOSE OF THE FOREIGN COMMERCE CLAUSE AND ITS ROLE IN REGULATING THE CONDUCT OF MULTINATIONAL COMMERCE AND COMMERCIAL RELATIONS UNDERSCORES THE UNCONSTITUTIONALITY OF CALIFORNIA'S ADOPTION OF FORCED WORLDWIDE COMBINED REPORTING

Article I, sec. 8, cl. 3 of the United States Constitution reserves to Congress the power "to regulate Commerce with foreign Nations and among the several states." James Madison summarized the prevailing view of the Framers in this regard in The Federalist: "If we are to be one nation in any respect, it clearly ought to be in respect to other nations." THE FEDERALIST No. 42, at 279 (J. Madison) (J. Cooke ed. 1961). His peer Alexander Hamilton commented more specifically on the import of the federal power to regulate foreign commerce:

> The want of a power to regulate commerce is by all parties allowed to be of the number [of defects in the pre-Constitutional Federal system]. . . . The want of it has already operated as a bar to the formation of beneficial treaties with foreign powers; and has given occasions of dissatisfaction between the States. *No nation acquainted with the nature of our political association would be unwise enough to enter into stipulations with the United States by which they conceded privileges of any importance to them, while they were apprised that the engagements on the part of the Union, might at any moment be violated by its members;* and while they found from experience that they might enjoy every advantage they desired in our markets, without granting us any return, but such as their momentary convenience might suggest.

THE FEDERALIST No. 22, at 135-137 (A. Hamilton) (J. Cooke ed. 1961) (emphasis added). Foreign commerce—particularly as represented by the Union's commercial

relations with Great Britain—continued to be a focus of concern and debate at the Convention to adopt the Constitution; one analysis of the defensibility of the dormant interstate Commerce Clause doctrine notes that the Commerce Clause limits on protectionism in foreign trade and commerce in transit are much more strongly supported in the Convention records than are such limits in interstate trade. *See*, R. COLLINS, Economic Union as a Constitutional Value, 63 N.Y.U. L. Rev. 43, 54 (1988).

Concern for foreign commerce protectionism has continued to have a high profile. This Court has acknowledged that the Commerce Clause, "by its own force created an area of trade free from interference by the States" and "even without implementing legislation by Congress is a limitation upon the power of the States." *Boston Stock Exchange v. State Tax Commission*, 429 U.S. 318, 328 (1977). Moreover, with regard to foreign commerce, the "constitutional prohibition against state taxation . . . is broader than the protection afforded to interstate commerce . . . because matters of concern to the entire nation are implicated." *Kraft General Foods, Inc. v. Iowa Department of Revenue and Finance*, —— U.S. ——, ——, 112 S. Ct. 2365, ——, 60 U.S.L.W. 4582, 4584 (1992); *see also Japan Line, Ltd. v. County of Los Angeles*, 441 U.S. 434, 448 n.13 (1979) (citing other Supreme Court cases recognizing this distinction); J. HELLERSTEIN, State Taxation I, Corporate Income and Franchise Taxes ¶ 4.14[2] (1983).

This Court articulated the "more extensive constitutional inquiry" to be made where the foreign Commerce Clause is implicated by a state taxing method in *Japan Line*. Two additional considerations distinct to taxes impacting foreign commerce supplement the four-prong interstate Commerce Clause test set out in *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274 (1977). First, notwithstanding apportionment, the state tax may not create a "substantial risk of international multiple taxation," *Japan Line*, 441 U.S. at 451. Second, a state

tax may not "impair federal uniformity in an area where federal uniformity is essential," by preventing the federal government from " 'speaking with one voice when regulating commercial relations with foreign governments.' " *Id.* at 448, 451. Impairment of federal uinformity is demonstrated where foreign nations disadvantaged by the state tax retaliate against American-owned entities or instrumentalities present in the foreign jurisdictions. *Id.* at 450.

It has ever been the understanding of the domestic business community that the foreign Commerce Clause protected it from the ramifications of state encroachment on federal commerce regulatory powers, including the power to determine the appropriate method of taxing foreign commerce. As multi-national commerce carried on by domestic corporations has evolved and developed under the auspices of the foreign Commerce Clause and as the potential for sovereign taxing systems to encroach one upon the other becomes more significant, the need for speaking "in one voice" as to matters of taxation of foreign commerce has become even more critical. Where a state does encroach upon the sovereignty of another nation, the foreign countries that are thus disadvantaged (*i.e.*, through the imposition of economic and administrative burdens on their domiciliary business entities) typically regard such incursions as a system-wide rather than a state-specific offense for purposes of response thereto. In this case, the United Kingdom has retaliated generally against domestic business with United Kingdom contacts; only a portion of such domestic business actually has contacts with California, and that portion by their very nature will have many or most contacts elsewhere. Thus, the entire core of domestic business having nexus with retaliating nations, and the states that have taken care to observe the tenets of federal policy, bear the brunt of retaliatory measures.

Barclays has demonstrated that the retaliatory measures against which American business rightly expects the federal Commerce Clause to provide protection have occurred in this case, and will reoccur if forced worldwide combination is not declared unconstitutional. The rejection by California of the federal (and indeed international) mandate of arm's length/separate accounting to divide international income for tax purposes and the State's substitute imposition of forced worldwide combination, has culminated in threats and acts of retaliation from 1978 forward of a magnitude beyond that previously experienced in this country. As documented in the *Barclays* trial record and acknowledged by the California Court of Appeal (a point completely ignored by the California Supreme Court), diplomatic protests were lodged with the United States by almost every developed country in the world, including direct protestations by Prime Minister Thatcher of the United Kingdom, Prime Minister Nakasone of Japan, and Prime Minister Trudeau of Canada directly to the President. The United States experienced significant problems in negotiating treaties with the Dutch and Germans, due to those countries' disfavor of California's taxing method. The Canadian and French treaty negotiators insisted on an exchange of notes which obligated the United States to reopen discussion with each country on the subject whether an acceptable solution could be devised. Trial Exs. 1 pp. 28-29, 32A, 32EE, 37F, 43, 46D, 46H, 72; Ct. of App. Slip. Op. at p. 40.

Madison and Hamilton's predictions two centuries ago were correct. The strongest reactions to and retaliatory measures against California's use of forced worldwide combination were registered by Great Britain, the nation whose commerce and trade strength instilled the greatest fear in the drafters of the foreign Commerce Clause. Great Britain followed up its early diplomatic efforts with respect to the aberrant California situation with the en-

actment in 1985 of retaliatory legislation that would deny certain previously agreed-upon treaty benefits to United States corporations operating in unitary states. At that time, the only recourse for American businesses to avoid the effect of such legislation—*i.e.*, not repatriating the dividends of United Kingdom subsidiaries—was unsatisfactory or harmful to their business operations, from the viewpoint of many. The passage of the water's edge legislation by California in 1988 stayed the implementation of Great Britain's retaliatory legislation but the threat of the implementation remained and was brought into play in 1993. Great Britain then notified targeted business entities as to the means and effect of implementation and United States corporations were faced with the economic burden of the proposed retaliation.

What are the ramifications of foreign retaliation against a state's unconstitutional taxing method for COST's member companies? Ensuring international, federal and state tax compliance becomes impossible. If companies are forced to devise alternative contingency plans to accommodate their shifting duties and liabilities every time a state taxing measure provokes threatened or real international retaliation, the evaluation of ongoing business and the evaluation of business opportunities becomes a guessing game rather than a business analysis. The ability to operate at all in various foreign countries often hinges on the nature of relations between the United States and such countries from moment to moment. The foreign Commerce Clause is the only shield domestic corporations can raise against the brunt of foreign economic retaliation that is deflected from the errant state and falls on corporations which have no culpable ties to the state.

The forced use of worldwide combined reporting is especially offensive to foreign nations and multinational businesses because it is wholly unnecessary. The entire world, with the exception of six states of the United States, manages to operate effective tax systems without thrusting

onerous record-keeping and compliance requirements on entities with no transactional or legal contact with the state that would impose those requirements. This Court has stated that as between arm's length separate accounting and worldwide combination there is little to recommend one system over the other. *See Container Corp. of America v. Franchise Tax Board*, 463 U.S. 159, 184-185 (1983). Whatever merit that conclusion may have in other contexts, in the context of foreign commerce there are at least three circumstances that favor the use of arm's length separate accounting. First, it is the method chosen by every national government, so its use is not capable of giving rise to any objection by any trading partner. Second, it is least likely to impinge on the sovereignty of any other nation because it concerns itself only with those transactions that by their cross-border nature invite that concern; it does not impose accounting and compliance burdens on entities whose activities have no contact with the taxing jurisdiction. Third, it is the method that the actions of the United States have led its trading partners to believe will be used to determine all tax liabilities and compliance requirements in the United States.

II. FORCED WORLDWIDE COMBINED REPORTING IS BEING UTILIZED BY SEVERAL STATES RATHER THAN INTERNATIONALLY SANCTIONED TOOLS; IN NO CASE IS THE METHOD EITHER NECESSARY OR JUSTIFIABLE

The practical importance of the question whether forced worldwide unitary combination is constitutional remains unabated by a state's "hit and run" ploy of instituting an unconstitutional tax measure and later repealing or reforming such legislation on the eve of (i) retaliatory action by a foreign nation or (ii) plenary judicial review by a state supreme court or by this Court. Although the Solicitor General claims to view *Barclays* as lacking "substantial recurring importance." *Am.* U.S. Br. No. 92-1384,

due to the State's enactment of water's edge legislation, this perspective is willfully myopic. In fact, the actual and potential utilization of worldwide combined reporting by states in addition to California continues to threaten the well-being of domestic business in the context of the world marketplace.

Alaska imposes forced worldwide combination on oil and gas companies. ALASKA STAT. § 43.20.073(f). Tennessee imposes worldwide combination on financial institutions. TENN. CODE ANN. § 67-4-817(d). While an election out of worldwide combination is available in Idaho, Montana, North Dakota and Utah, specific features of these states' methods may in effect force corporate taxpayers back into worldwide combined reporting, or include select foreign affiliates in the combined group. For instance, the Idaho State Tax Commission may disregard a water's edge election if any corporation is deemed to have failed to comply with the domestic disclosure spreadsheet requirement or the State's legal and procedural requirements. IDAHO CODE § 63-3027B(c). *See also* MONT. ADMIN. R. 42.26.224; *cf.* N.H. REV. STAT. ANN. § 77-A:6, IV. North Dakota includes foreign corporations in a unitary group that files a water's edge election, if over 50% of the voting stock of the foreign corporations is owned directly or indirectly by an affiliated corporation and more than 20% of the average of its payroll and property is assignable to locations in the United States (not specifically North Dakota). N.D. CENT. CODE §§ 57-38.4-01 and 57-28.4-02. Effective taxable years beginning on or after January 1, 1994, Utah includes 100% of a foreign operating company's income (prior law included 50%) on a water's edge combined report. UTAH CODE ANN. § 59-7-304(1).

Each of the above-referenced states has a tool or a policy which it could effectively utilize to reach income that has been shifted to an inappropriate taxing jurisdiction. These means may be utilized without encroaching on the

sovereignty of other nations and precipitating the retaliation that would attend that encroachment. As noted above, this tool has been sanctioned by the entire world.

CONCLUSION

For the reasons set forth above, the Committee on State Taxation respectfully requests that the decisions of the California Supreme Court in *Barclays* and *Colgate-Palmolive* be reversed.

Respectfully submitted,

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Nos. 92-1384 and 92-1839

In The
Supreme Court of the United States
October Term, 1993

BARCLAYS BANK PLC,
Petitioner,
vs.
FRANCHISE TAX BOARD,
An Agency of the State of California,
Respondent.

COLGATE-PALMOLIVE COMPANY,
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On Writs of Certiorari to the Court of Appeal of the State of California in and for the Third Appellate District

BRIEF OF CONGRESSMEN DON EDWARDS, HOWARD L. B..RMAN AND XAVIER BECERRA AS AMICI CURIAE IN SUPPORT OF RESPONDENT FRANCHISE TAX BOARD

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QUESTIONS PRESENTED

Whether the Court should change the foreign policy of the United States with respect to State taxes after the Legislative and Executive Branches have refused to and, if so,

Whether the Commerce Clause requires a State to use a different accounting system to allocate profits for foreign corporations than it does for domestic corporations when Congress has refused for over thirty years to require such action?

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INTEREST OF AMICI

Amici appear before the Court as individual Members of Congress whose service on the Committee on the Judiciary of

the House of Representatives has given them a unique understanding of the issues presented by these cases that will be useful to the Court.[1]

The Judiciary Committee has general jurisdiction over the protection of trade and commerce against unlawful restraints and monopolies, Rule X. 1.(m)(16), Rules of the House of Representatives, and specific jurisdiction over bills regulating the authority of States to impose taxes on interstate commerce. 105 Cong. Rec. H. 11317 (June 18, 1959). As members of the Committee of the House of Representatives with specific subject matter jurisdiction, amici have a direct and continuing interest in the subject matter of these cases. Any legislation to reverse or modify this Court's decision in these cases would be brought to the Committee for its consideration and action.

SUMMARY OF ARGUMENT

Questions regarding State taxation of interstate and foreign commerce under the Constitution have always been directed in the first instance to Congress. The circumstances of these cases demonstrate the wisdom of this Court's policy of deferring to the judgment of Congress in these matters.

The States' refusal to use the "arm's-length" accounting method for allocating multinational companies' income has been the subject of extended Congressional consideration for over thirty years, but no legislation has been passed. Indeed, the United States Senate rejected a treaty proposed by the United Kingdom that would have prohibited States from using unitary accounting methods for multinational corporations.

[1] Amici submit this brief in support of Respondent with the consent of all parties. Written consents are on file with the Clerk of the Court.

The United Kingdom accepted that rejection after additional negotiations and concessions by the United States.

The political process has worked. Congress made an informed, conscious decision to allow the States to continue to use unitary accounting methods to allocate the income of multinational corporations. California exercised its discretion and decided to allow multinational corporations the choice of having the method applied to them effective January 1, 1988, Barclays Joint Appendix (BJA), Ex. 55, BJA-696, subsequently modified in 1993 by Senate Bill 671 (Cal. Stats. 1991, Ch. 881). See Respondent's Supplemental Brief in Opposition to Petition, Appendix A.

There is no constitutional justification for this Court to second guess the political process of the States and Congress and give Barclays special treatment just because it is a foreign corporation or give Colgate special treatment just because it conducts part of its business in foreign countries. The tax prerogatives of the States are determined by the elected officials in the States and the United States Congress after due deliberation; they should not be dictated by the wishes of corporate taxpayers or of foreign governments seeking to gain a competitive advantage for their own companies, which have the ability to shift massive amounts of profit abroad.

ARGUMENT

INTRODUCTION

The paramount question in these cases is whether a State is required by the Commerce Clause to use a different, and easier to evade, accounting standard to allocate profits for foreign corporations than it does for domestic corporations. Subsumed within this question is the more fundamental

question of how to strike a balance between State and national sovereignty under our federal system. The other issues raised by the parties involving the treaty power, foreign affairs, and supremacy are all derivative of the Commerce Clause question.

The requirements of the Commerce Clause and the subsidiary questions must be answered by reference to the Constitution, not by the demands of foreign nations seeking favored treatment for their corporations. The Constitution provides directions for the division of several specifically identified responsibilities and powers within a system of checks and balances.[2] In addition, as part of the Bill of Rights, the Tenth Amendment provides that "The powers not delegated to the United States by the Constitution, nor prohibited by it to the States, are reserved to the States respectively, or to the people."

This reservation of powers to the States is enforced through the structure of the federal government. "[T]he principal means chosen by the Framers to ensure the role of the States in the federal system lies in the structure of the Federal Government itself. It is no novelty to observe that the composition of the Federal Government was designed in large part to protect the States from overreaching by Congress." *Garcia v. San Antonio Metropolitan Transit Authority*, 469 U.S. 528, 550-551 (1985). Thus, the structure of Congress, consisting of two houses made up of representatives of the States, assures that the powers delegated to the federal

[2] The powers of the Legislative Branch, art. I, § 8, and Executive Branch, art. II, § 2, are described with some specificity. Limitations on the powers granted to the United States are enumerated, art. I, § 9, as are powers prohibited to the States, art. I, § 10.

government under the Constitution "will partake sufficiently of the spirit [of the States], to be disinclined to invade the rights of the individual States, or the prerogatives of their governments." *Id.* at 551 (internal quotations omitted). The Senate, in particular, with two members from each State and a restriction on the ability to change this characteristic by amendment is "at once a constitutional recognition of the portion of sovereignty remaining in the individual States, and an instrument for preserving that residuary sovereignty." *Id.* at 551-552 (internal quotations omitted).

In forming the federal government, the States agreed to cede a portion of their individual sovereign powers in order to enhance their collective power. Two of the principal motivating factors for the formation of the Union were: 1) the desire to conduct commerce, whether between themselves or with other nations, free of selfish impediments, and 2) the conduct of relations with foreign governments.

In furtherance of the first objective, Congress was given the power "[t]o regulate commerce, with foreign nations and among the several states. . . ." U.S. Const., art. I, § 8, cl. 3. To achieve the second of these objectives, the President was given "the power, . . . to make treaties. . ." art. II, § 2, cl. 2. The President's power, however was subject to the limitation that it could only be exercised "with the advice and consent of the Senate . . . provided two-thirds of the Senators present concur. . . ." *Id.* Thus, the structure of our federal government guarantees the States a voice in the establishment of both foreign and domestic policy through their representatives in Congress.

Maintaining this voice in the tax area is critical. Without the ability to raise revenue, a government loses the ability to provide the services for which it was formed. As a consequence, the States, in forming our Union, jealously guarded their revenue base. The Constitution directly limits State tax prerogatives only in the case of "imposts or duties on imports or exports," U.S. Const., art. I, § 10, cl. 2. There is no other specific prohibition on State taxation.

I. SINCE THE ISSUES IN THESE CASES HAVE BEEN INTENSIVELY CONSIDERED BY BOTH HOUSES OF THE CONGRESS, THIS COURT SHOULD ACCEPT THE JUDGMENT OF THE CONGRESS.

A. This Court Appropriately Defers To Congressional Consideration Of State Tax Issues Because They Involve Delicate Issues of Federalism.

In 1983, this Court decided that the taxes here at issue as applied to a domestic-based unitary business were constitutional under a Dormant Commerce Clause analysis. *Container Corporation of America v. Franchise Tax Board*, 463 U.S. 159 (1983). Since that time, the Congress has had numerous opportunities to change the result of that decision.[3] It has not done so. Indeed, recent efforts by the Administration to revise the federal "arm's-length" method to

[3] A list of some of the bills which have been introduced in Congress which would have affected the States' use of worldwide combined reporting is set forth in Stip. ¶ 38, BJA-40. None of these bills has been enacted. A list of the hearings which have been held by various Committees of Congress is set forth in the Joint Stipulation at ¶ 37, BJA-23-24.

prevent multinational corporations from continuing to evade about $30 billion of federal taxes have not derailed public pressure to adopt a federal unitary method of taxing multinational corporations. *See*, Lobel, Banta & Gueron, *Barclays: A Test of the Administration's Willingness to Collect Taxes From Multinational Corporations*, Tax Notes, June 28, 1993, at 1841; John B. Judis, *Tax Brake, Clinton's Corporate Giveaway*, The New Republic, August 23, 1993, at 15.

Congress' repeated refusal to alter the result of *Container* should be respected by this Court. This Court should take the same position it took only eighteen months ago when it refused to overrule one of its prior decisions on a State tax, admittedly at odds with contemporary Commerce Clause jurisprudence. In part, this Court's reluctance was because Congress had the power to change the decision and was better equipped to balance the competing interests. *Quill Corporation v. North Dakota*, 504 U.S. ___, 119 L.Ed.2d 91 (1992).

If this Court takes its own counsel as set forth in *Quill*, it will respect the judgment of the Congress and sustain the taxes in dispute. California has amended its tax code to relieve the concerns of foreign governments. If any additional action is required, Congress has the power and a more appropriate institutional perspective than this Court to strike the necessary balance between the rights of the States and the concerns of foreign governments.

In order to preserve the delicate balance of our federal system, this Court has generally required "clear and manifest" affirmative action by Congress before it strikes down a non-discriminatory State law. *Puerto Rico Dept. of Consumer*

Affairs v. Isla Petroleum Corp., 485 U.S. 495, 500 (1988). For example, this Court sustained a State tax that differed from the federal tax, even when Congress thought State law would follow federal law, because Congress did not *require* States to follow federal law. *Amerada Hess Corp. v. New Jersey*, 490 U.S. 66, 70 (1989).

Indeed, this Court has upheld State taxes even when it apparently questioned the wisdom of the tax. For example, in 1981, this Court reviewed a severance tax imposed by the State of Montana on the mining of coal. The tax was imposed at the height of the energy crisis and was vociferously opposed by residents of less energy blessed states who used Montana's coal. This Court found the tax permissible under the Commerce Clause. "Under our federal system, the determination is to be made by state legislatures in the first instance and, if necessary, by Congress when particular state taxes are thought to be contrary to federal interests." *Commonwealth Edison Company v. Montana*, 453 U.S. 609, 628 (1981).

As Justice White stated in his concurrence:

> . . . Congress has the power to protect interstate commerce from intolerable or even undesirable burdens. . . . Yet, Congress is so far content to let the matter rest, and we are counseled by the Executive Branch through the Solicitor General not to overturn the Montana tax as inconsistent with either the Commerce Clause or federal statutory policy in the field of energy or otherwise. The constitutional authority and the machinery to thwart the efforts such as those of Montana, if thought unacceptable, are available to Congress, and surely Montana and other

> similarly situated States do not have the political power to impose their will on the rest of the country. . . . the better part of both wisdom and valor is to respect the judgment of the other branches of the Government. 453 U.S. at 637-638.

If anything, under the reasoning of this Court in *Commonwealth Edison*, even greater deference should be given to State income taxes because the interests of the taxpayers have almost certainly been considered by the elected officials. In *Mobil Oil Corporation v. Commissioner of Taxes*, 445 U.S. 425 (1980), this Court recognized the special character of income taxation:

> Concurrent federal and state taxation of income, of course, is a well-established norm. Absent some explicit directive from Congress, we cannot infer that treatment of foreign income at the federal level mandates identical treatment by the States. The absence of any explicit directive to that effect is attested by the fact that Congress has long debated, but has not enacted, legislation designed to regulate state taxation of income. . . . Legislative proposals have provoked debate over issues closely related to the present controversy [apportionment and taxation of dividend income]. . . . Congress in the future may see fit to enact legislation requiring a uniform method for state taxation of foreign dividends. To date, however, it has not done so. (Citations omitted.) 445 U.S. at 448-449.

This Court found this to be true even when a different unitary formula was used by a State:

> While the freedom of the States to formulate independent policy in this area may have to yield to an overriding

national interest in uniformity, the content of any uniform rules to which they must subscribe should be determined only after due consideration is given to the interest of all affected States. It is clear that the legislative power granted to Congress by the Commerce Clause of the Constitution would amply justify the enactment of legislation requiring all States to adhere to uniform rules for the division of income. It is to that body, and not this Court, that the Constitution has committed such policy decisions. *Moorman Manufacturing Company v. Bair*, 437 U.S. 267, 280 (1978).

This Court's judgment that issues involving State taxation and the Commerce Clause should be resolved under the Constitution by action of the Congress because it is better designed to balance the concerns of the States and the taxpayers is sound and should be respected. *See* Chapman, *Chadha, Garcia and the Dormant Commerce Clause Limitation on State Authority to Regulate*, 23 Urban Lawyer 163 (1991).

B. Over The Last Thirty Years Congress Has Consistently Refused To Pass Legislation Limiting The States' Power To Use The Unitary Method Of Allocating Income For Multinational Companies.

There is no question that the issues raised in these cases have been exhaustively reviewed by Congress. Every effort to prohibit the State taxes at issue has been rejected.

Shortly after the Court's decision in *Northwestern States Portland Cement Company v. Minnesota and Williams v. Stockham Valves & Fittings, Inc.*, 358 U.S. 450 (1959),

Congress enacted Pub. L. No. 86-272 which, among other things, "initiated a comprehensive study of all matters pertaining to the taxation of income derived from interstate commerce. . ." *State Taxation of Interstate Commerce: Report of the Special Subcommittee on State Taxation of Interstate Commerce, Committee on the Judiciary, House of Representatives*, 88th and 89th Cong., 1st and 2d Sess. (1964-1965), Vol. 1, p. 8.

The Judiciary Committee of the House of Representatives formed a special Subcommittee to study the issues presented by State taxation of corporate income. The Subcommittee conducted its study and hearings over several years. The results of this study are contained in five separate volumes and total over 2,600 pages of text and appendices. *State Income Taxation of Mercantile and Manufacturing Corporations: Hearings before the Special Subcommittee on State Taxation of Interstate Commerce of the Committee on the Judiciary House of Representatives*, 86th and 87th Cong., (1961-1962) and *State Taxation of Interstate Commerce: Report of the Special Subcommittee on State Taxation of Interstate Commerce, Committee on the Judiciary, House of Representatives*, 88th and 89th Cong., 1st and 2d Sess. (1964-1965), Vol. 1-4. Two of the issues considered in these volumes are whether States should be able to use combined reporting unitary accounting and whether States should be able to consider income and activities outside of the United States in computing State taxes on multinational corporations. These are the issues presented by these cases. No legislation was enacted as a result of these hearings, study and report.

Additional hearings were held by the same Subcommittee in 1966 which resulted in an 1,800 page report. *Interstate*

Taxation Act, H.R. 11798 and Companion Bills: Hearings before the Special Subcommittee on State Taxation of Interstate Commerce of the Committee of the Judiciary, House of Representatives, 89th Cong., 2d Sess. (1966). Not one of the bills to limit unitary taxation of foreign corporations was enacted.

Similar hearings were held in 1973. *Hearings before the Subcommittee on State Taxation of Interstate Commerce of the Committee on Finance, United States Senate*, 93rd Cong., 1st Sess. (1973).

In 1977 and 1978, hearings were held with respect to federal regulation of state income taxation of interstate and foreign commerce. *Interstate Taxation, S. 2173: Hearings before the Senate Committee on the Judiciary*, 95th Cong., 1st and 2d Sess. (1977-1978). Stip. ¶ 37G, BJA-24.[4]

In 1980, the Senate Finance Committee held hearings on an Interstate Tax Bill, the primary purpose of which was to prohibit State use of worldwide combined reporting (WWCR) the unitary accounting method at issue in these cases. *State Taxation of Interstate Commerce and Worldwide Corporate Income, 1980: Hearings on S. 983 and S. 1688 Before the Subcomm. on Taxation and Debt Management Generally of the Senate Comm. on Finance*, 96th Cong., 2d Sess. (1980). Stip. ¶ 37E, BJA-24.

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[4] The hearings in 1977-78 are of particular significance because they occurred at the time the United States Senate was considering whether it would give its advice and consent to the United States/United Kingdom Income Tax Convention with its restriction on State consideration of the activities of United Kingdom-based businesses to determine the income earned within the State. *See infra*, at pp. 14-19.

Also in 1980, the House of Representatives' Committee on Ways and Means held hearings on H.R. 5076,[5] the purpose of which was to prohibit the States' use of WWCR. No vote on the bill was even taken by the Committee.

In 1986, a Subcommittee of the Senate Finance Committee held hearings on S. 1113 and S. 1974, bills which were specifically introduced to limit the States' ability to use WWCR. These bills never even went to a Committee vote.

In *Commonwealth Edison Company v. Montana*, 453 U.S. 609 (1981), this Court pointed out that there had been Congressional consideration of the level of the Montana severance tax in both the 96th and 97th Congresses. 453 U.S. at 628, fn. 18. Contrast this with over thirty years of Congressional consideration of WWCR. If the consideration of six bills over two Congresses carries significance, then certainly importance should be attached to the consideration of over twenty bills during more than ten Congresses, Stip. ¶ 38, BJA-24-25, at least nine Congressional hearings, Stip. ¶ 37, BJA-23-24 and Second Stip. ¶ 37, BJA-47, and, as discussed below, the rejection of a treaty prohibition on the tax at issue.

Multinational corporations and foreign governments certainly know how to make their views known to Congress. *See*, Brooks Jackson, *Honest Graft*, Alfred A. Knopf, New York, 1988. Congress, however, has refused their entreaties, as should this Court.

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[5] The report of those hearings is included in the record of this case. Stip. ¶ 37D, BJA-24.

C. Since The Senate Refused To Give Its Consent To A Treaty Prohibiting The Taxes At Issue Here, This Court Should Accept The Senate's Judgment.

In determining whether a State tax impinges on the federal government's ability to conduct foreign affairs, the affirmative action of the Senate in refusing to consent to a treaty with a prohibition on State unitary taxes should be dispositive. In establishing the treaty power, and in making it subject to the advice and consent of two-thirds of the Senate, the Framers had in mind the protection of the States against untoward encroachment on their sovereign powers by the federal government. Whether a State tax is a foreign policy concern of the United States is for Congress and the Executive to decide, not foreign governments.

In 1975, the United States and the United Kingdom concluded negotiations on revisions to the then-existing income tax treaty between the countries. One of the provisions included in the renegotiated treaty was a clause, Article 9(4), which would have limited the ability of the States to use WWCR on United Kingdom-based businesses such as Barclays. In submitting the treaty to the United States Senate for its advice and consent, the Executive Branch noted that this was the first treaty involving income taxation in which such a limitation on the States had been included. Letter of Submittal, June 8, 1976, 3 Tax Treaties Reporter (CCH) ¶10,938.

The proposed limitation on State (subnational) taxation contained in Article 9(4) was the subject of intense debate both within the Foreign Relations Committee and on the floor

of the United States Senate. Senator Frank Church attempted to attach a reservation to the treaty with respect to Article 9(4) both in Committee and on the Senate floor. One of his concerns was the use of the treaty process to circumvent Congressional consideration of an action which would affect commerce. See Ex. 36C, BJA-238, and 36D, BJA-311, generally, and especially BJA at 251-254. The efforts to attach a reservation failed.

However, when the treaty was presented to the Senate on June 28, 1978, for its advice and consent, the vote was 49 in favor and 32 against. The treaty failed to obtain the necessary consent of the United States Senate. 124 Cong. Rec. S. 18670 (June 23, 1978). The next day, the treaty, after the reservation of Article 9(4) was appended, passed the Senate by the constitutionally required two-thirds affirmative votes, 82 in favor and 5 against. 124 Cong. Rec. S. 19076 (June 27, 1978).

The treaty, as approved by the Senate, was returned to the Executive Branch, which transmitted it to the United Kingdom for its reconsideration. Because of the change in the treaty, the United Kingdom requested that negotiations be reopened. The United States agreed, and the additional negotiations gave rise to the Third Protocol to the Treaty which made additional concessions to the United Kingdom as the result of the Senate's reservation on Article 9(4).

The Third Protocol was considered by the United States Senate on July 9, 1979 and passed 98 in favor, to 0 against. 125 Cong. Rec. S. 17434 (July 9, 1979). Ex. 36B, BJA-193 at 227-229. The United Kingdom then approved the treaty as modified, and it became effective on March 24, 1980.

With a much weaker expression of intent by Congress, this Court ruled in *Wardair Canada v. Florida Department of Revenue*, 477 U.S. 1 (1986), that a State was not preempted from imposing a tax affecting foreign commerce. This Court in *Wardair* had before it: 1) a multilateral international convention which exhibited awareness of a similar state tax that was prohibited and silence with respect to the tax at issue, 2) a resolution of an international organization which would have prohibited the specific tax, and 3) bilateral agreements adopted after the resolution which committed the United States not to assert taxes at the national level similar to the State tax at issue but which were silent with respect to subnational taxes. This Court found that the second of these items, the Resolution, was of little relevance because it had not been endorsed or adopted by the federal government. The other two items, however, were found by this Court to establish that the State tax was expressly permitted. This Court said, "the Federal Government is entitled in its wisdom to act to permit the States varying degrees of regulatory authority. In our view, the facts presented by this case show that the Federal Government has affirmatively decided to permit the States to impose these . . . taxes. . . ." *Id.* at 12, and concluded that, "we never suggested . . . that the Foreign Commerce Clause *insists* that the Federal Government speak with any particular voice." (Emphasis in original.) *Id.* at 13.

The *Wardair* analysis compels the conclusion that the Senate's rejection of the proposed clause in the US/UK income tax treaty is an affirmative decision by the federal government to permit the State tax here at issue. There is no need to look to other bilateral agreements whose history is silent with respect to the relevant issue. There is no need to

look to the agreements of international organizations which suggest one thing and bilateral agreements which do something else *sub silentio*. All that is required is to look to the Senate's consideration and rejection of the proposed limitation on State tax prerogatives. This action does more than manifest permission by implication; it does it by action, action which was understood as permission both by the United States and the United Kingdom who were parties to the treaty, by the States and commercial enterprises who would have been affected by a prohibition, and by other countries as well.[6]

Congress is charged with the responsibility of regulating Commerce. The Senate, as one of the houses of Congress, bears this responsibility directly in considering legislation. It also performs this function when it is required to give its advice and consent to a treaty involving commercial relations with foreign countries. In considering the US/UK tax treaty, specifically Article 9(4), the Senate performed its role as guardian of State prerogatives.

> [T]he principal and basic limit on the federal commerce power is that inherent in all congressional action — the built-in restraints that our system provides through state participation in federal governmental action. The political process ensures that laws that unduly burden the States will not be promulgated. In the factual setting of these cases the internal safeguards of the political process have performed as intended. *Garcia*, 469 U.S. at 556.

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[6] See Ex. 42, BJA-477 and Ex. 43, BJA-480.

Barclays claims that the State tax here at issue fails what is commonly known as Dormant Foreign Commerce Clause analysis because it "prevent[s] this Nation from 'speaking with one voice' in regulating foreign commerce." *Japan Line, Ltd. v. County of Los Angeles*, 441 U.S. 434, 451 (1979). Alternatively, Barclays claims that California's tax is invalid because it impinges upon the ability of the federal government to conduct the foreign affairs of the United States. The same analysis applies to both arguments, *Japan Line*, 441 U.S. at 449 (1979); *Michelin Tire Corp. v. Wages*, 423 U.S. 276 (1976), particularly when the President negotiates a treaty affecting the commercial relations of the United States.[7]

Barclays' reliance on *Japan Line* is misplaced. *Japan Line* deals with a property tax, not an income tax. In that case, the federal government, by treaty, recognized that the international movement of cargo vessels should not be impeded by State taxes and, thus, there was a need to "speak with one voice." The taxation of multinational corporations' income raises entirely different concerns because they have the ability to shift income among a complex web of subsidiaries carefully designed to evade taxes. This Court has recognized that protecting the tax status of vessels and containers is vastly different than granting constitutional protection to the accounting artifices created by the tax departments of multinational corporations. Compare *Japan Line* with

[7] Because treaties often address commercial issues, the Constitution, art. II, § 2, cl. 2, provides that a treaty only becomes effective when two-thirds of the Senators present when it is considered give their advice and consent.

Container, which dealt with the same tax as is at issue in these cases and was decided four years later.

II. SINCE CONGRESS HAS DECIDED THAT THE STATES' USE OF THE UNITARY METHOD DOES NOT PREVENT THE GOVERNMENT FROM "SPEAKING WITH ONE VOICE," THIS COURT SHOULD NOT SUBSTITUTE ITS JUDGMENT FOR THAT OF CONGRESS

In *Container*, this Court recognized that the overlapping Commerce Clause and foreign affairs Constitutional questions are peculiarly political in nature. In making the "one voice" element part of its Commerce Clause analysis in *Container*, this Court recognized its institutional limitation in considering these issues:

> . . . In considering this issue, however, we are faced with a distinct problem. This Court has little competence in determining precisely when foreign nations will be offended by particular acts, and even less competence in deciding how to balance a particular risk of retaliation against the sovereign right of the United States as a whole to let the States tax as they please. 463 U.S. at 194.

This Court stressed that the "one voice" element was peculiarly an issue for the Executive and Legislative Branches:

> . . . the foreign policy of the United States — whose nuances, we must emphasize again, are much more the province of the Executive Branch and Congress than of this court. 463 U.S. at 196.

The "one voice" analysis involves determining whether a state tax will "impair federal uniformity in an area where federal uniformity is *essential*." (Emphasis added.) *Japan Line*, 441 U.S. at 448. In *Container*, this Court said that uniformity might be essential if the State tax "might *justifiably* lead to significant foreign retaliation." (Emphasis added.) 463 U.S. at 194. The facts of this case demonstrate that suppressing a State's right to choose its tax system is not essential to uniformity and the retaliation threatened by the United Kingdom was resolved by the political system.

In any event, once United States foreign policy has been made, suggesting that the Constitution requires it be changed in the face of foreign threats is a dangerous precedent. It would encourage threats and retaliatory legislation where none would have been considered.

A. Congress Has Decided That Identical Taxation Of Multinational Corporations By The States And Federal Government Is Not Essential For Our Country To Speak With "One Voice" In Foreign Policy.

This Court recognized in *Container* that the determination of whether uniformity in this area is *essential* is a decision which must be made in the first instance by the Executive and Legislative Branches, 463 U.S. at 194. Congress' refusal to pass any one of innumerable bills to prohibit the States' use of WWCR for almost thirty years evidences a conviction that uniformity in this area is not essential. If it were, Congress would have acted.

Circumstances have proved Congress to be correct. Foreign commerce continues. Residents of the United

Kingdom, the nation that has gone the furthest in threatening retaliation, continue to be among the single biggest investors in the United States[8] and in California.[9]

B. Threats Of Retaliation By Foreign Governments Should Be Handled By The Political System, Not This Court.

The United States' Income Tax Conventions, except with respect to non-discrimination, do not apply to taxes asserted by subnational jurisdictions such as States. *E.g.*, The United States Model Income Tax Treaty. Ex. 45, BJA-560. In presentations to international groups, representatives of the Treasury have stated that the United States will not include subnational taxes under treaties, with the exception of nondiscrimination, because the Senate will not approve it. See Ex. 37H, BJA-436 at 438.[10] Because these foreign governments have been unable to get the Executive and Congress to change the policy of the United States government, they are now asking this Court to change the policy of the United States as a matter of constitutional law.

Despite the additional benefits the United Kingdom got because it accepted the US/UK tax treaty without a prohibition on State taxation, it reneged on the deal and threatened to

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[8] *Foreign Direct Investment in the United States: An Update*, U.S. Dept. of Commerce (June 1993), p. 23.

[9] *Foreign Direct Investment in California*, State of California (Nov. 1993), pp. 4-5.

[10] Material is from a submission by the Department of Treasury to XIX Inter-American Center on Tax Administrators (CIAT) Technical Conference on "Exchange of Information Under Tax Treaties" August 28-September 3, 1977, Curacao. Ex. 37H. *International Tax Treaties: Hearing before the Senate Comm. on Foreign Relations*, 96th Cong., 1st Sess. (June 6, 1979), p. 111-112 (statement of Donald C. Lubick).

withdraw a benefit which the same treaty conferred upon United States corporations, Ex. 40GG, BJA-444 at 455-459, Article 10, because of the States' continued use of WWCR. The United Kingdom has now withdrawn the threat of retaliation, but holds it in reserve if it is displeased with California's implementation of its new "water's-edge" legislation or if another State should choose to adopt WWCR. *See* State Tax Notes, 93 STN 181-16 (September 20, 1993). This Court should not encourage the United Kingdom to hold hostage either United States foreign policy or United States internal policy regarding the powers of the States.

Perhaps one reason the United Kingdom threatened to breach the treaty is because unitary accounting undercuts the *raison d'etre* of British tax havens such as the Channel Islands, the British Virgin Islands, Gibraltar, Hong Kong and the Cayman Islands, which are used by offshore corporations to evade taxes under the "arm's-length" method of accounting. In fact, the Crown Colony of the Cayman Islands is now the fifth largest banking center in the world.

C. The Practical Effect Of Limiting Use Of The Unitary Method Will Be To Impair The Ability Of American Companies To Compete Against Foreign Companies.

Although the legal issue in the *Barclays* case is whether it is constitutional for a State to impose the same tax accounting requirements faced by domestic companies upon foreign multinational corporations, the real issue is whether foreign multinational corporations will be allowed to shift their tax burden onto domestic corporations as a matter of constitutional law. If Barclays prevails, domestic companies will be forced

to pay the taxes that the foreign companies will escape. Indeed, if Barclays prevails, our domestic companies will have to compete against foreign corporations which pay no income taxes whatsoever on their exports to the United States because in many countries there is no corporate income tax, only a Value Added Tax on products which is rebated to a corporation if it exports the product.

The "arm's-length" method used by the federal government essentially allows a corporation to use intra-company sales as a method of allocating income. For example, if a Japanese auto manufacturer sold a car to its U.S. distributor for $30,000, its U.S. distributor might sell it for $32,000. After deducting administrative and advertising costs for its U.S. subsidiary, the Japanese company could declare that it lost money on the sale in the U.S. even if it booked a $10,000 profit on that car in Japan when it sold it to its U.S. distributor.

Unfortunately, trying to police the "arm's-length" system is like trying to police the New Jersey turnpike on a bicycle. According to every former Commissioner of the Internal Revenue Service who testified before the Oversight Subcommittee of the House Ways and Means Committee, the IRS is totally outgunned by these corporations when it somehow discovers an egregious example of revenue shifting and tries, using the "arm's-length" method, to collect the taxes that should have been paid.[11] In an attempt to stop some of

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[11] *Tax Underpayment by U.S. Subsidiaries of Foreign Companies: Hearings Before the Subcommittee on Oversight of the Committee on Ways and Means, House of Representatives*, 101st Cong., 2d Session, July 10 and 12, 1990, at 41.

(continued...)

the abuse, the IRS recently issued complex temporary regulations,[12] but so far all they appear to have generated are seminars in vacation spots for lawyers, accountants and economists eager to learn how to work the system for their clients and a spate of articles moaning about the onerous burdens being imposed by these new regulations.[13]

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[11](...continued)

In 1992, the Subcommittee revisited the 36 firms it studied in 1990 and found that these firms actually paid less taxes than reported originally. *Department of the Treasury's Report on Issues Related to the Compliance with U.S. Tax Laws by Foreign Firms Operating in the United States: Hearings Before the Subcommittee on Oversight of the Committee on Ways and Means, House of Representatives*, 102d Cong., 2d Sess., April 9, 1992, at 5.

[12] 26 CFR §§ 1.481.1 through 1.483-2T, 58 Fed. Reg. 5263 (June 21, 1993).

[13] Witnesses Say Transfer Pricing Penalty Regs are Too Restrictive, Tax Notes, May 24, 1993, p. 1005; Panels Ponder Foreign Tax Issues, Tax Notes, May 17, 1993, p. 877; William L. Raby, CPA, Section 482 and the Under $10-Million Corporation, Tax Notes, March 22, 1993, p. 1637; James P. Fuller and Ernest F. Aud, Jr., The New Temporary and Proposed Section 482 Regulations: A Wolf in Sheep's Clothing?, Tax Notes, March 15, 1993, p. 1517; Transfer Pricing Regs Don't Require Proving a Negative, Official Says, Tax Notes, March 15, 1993, p. 1413; Burgess J. Raby and William L. Raby, Section 482 Reasonable Cause Proposal Not Reasonable, Tax Notes, March 8, 1993, p. 1347; Kellogg Management School Conducts Conference on Transfer Price Regs, Tax Notes, February 22, 1993, p. 1015; John Simpson et al., From "CPI or Die" to the Best Method Rule: An Economic Analysis of the Arm's Length Standard Under the New IRS Regulations for Intercompany Pricing, Tax Notes, February 22, 1993, p. 1089; Steven P. Hannes, Esq., An Evaluation of IRS's 1993 Transfer Pricing and Related Penalty Proposals: Round Three, Tax Notes, February 15, 1993, p. 933; Treasury's Mogle Offers Insights on New Transfer Pricing Regs, Tax Notes, February 8, 1993, p. 683; George N. Carlson, et al., Deja Vu All Over Again: The New Section 482 Regulations, Tax Notes, February 1, 1993, p. 607; IRS Releases Temporary Transfer Pricing Regs, Tax Notes, January 18, 1993, p. 287.

Under these circumstances, it is hopelessly naive to believe that profit-maximizing corporations, making any kind of a cost-benefit calculation, will not structure their accounting to minimize taxes. Given a vague standard and ineffectual enforcement, it would be inconceivable not to expect managers to do all they can to shift revenue to the lowest tax jurisdiction. The rewards weighed against the risks are simply too great. No public policy should be based on a notion that corporate managers are more virtuous or public spirited than the general run of mankind.

A June 1993 Commerce Department Report to Congress on Foreign Direct Investment in the United States estimated that one half of the taxes owed by foreign multinational corporations were evaded by transfer pricing abuses. By one estimate that is about $30 billion a year[14] — real money even in federal government terms. According to the IRS, in 1989, the last year for which data is available, 71.7% of foreign companies paid no U.S. taxes at all and, as a group, reported less than one third the taxable income of U.S. firms as a percentage of receipts (.9% v. 3.1%) despite the fact that their

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[14] A study by Professor James A. Wheeler summarized in Lobel, Banta & Gueron, *Barclays: A Test of the Administration's Willingness to Collect Taxes from Multinational Corporations*, Tax Notes, June 28, 1993, at 1842. *See also* a study by Professors Pak and Zdanowicz reported in Tax Analysts Highlights & Documents, January 11, 1994, at 11, which estimated that "Foreign-held firms used transfer pricing shenanigans to dodge an estimated $28 billion or more in federal income taxes in 1992. . . ." They "found that trade with Japan accounted for an estimated 13 percent of lost U.S. income tax revenues, or more than $4 billion annually. Other countries with "abnormalities" exceeding $1 billion were: Germany ($3.1 billion); Britain ($2.5 billion); Canada ($2.1 billion); France ($1.6 billion); Mexico and Taiwan ($1.4 billion); the Netherlands ($1.3 billion); and Brazil ($1.1 billion)."

assets went up three times as fast as domestic companies. Apparently, they are losing money on every sale, but making it up in volume!

Because these foreign corporations failed to get Congress to prohibit State use of unitary tax systems that this Court has consistently recognized as at least as accurate a method as the "arm's-length" method of allocating income, *Allied-Signal v. Dir. Div. of Taxation*, 504 U.S. ___, 119 L.Ed.2d. 533 (1992), they are now asking this Court to prohibit State use of unitary tax systems against foreign multinational corporations on constitutional grounds. They argue that unitary tax systems are too burdensome to apply and violate international standards. The first point doesn't even pass the smile test: How can the management of a corporation suggest with a straight face that it does not know where its sales, personnel and property (the usual factors in unitary accounting systems) are located? On the second point, the one time such a prohibition was included in a treaty, the Senate refused to pass the treaty until the prohibition was removed.

The only consistent theme in the multinationals' argument against the unitary method of allocating income or against making the "arm's-length" method more effective is that they don't want to pay taxes. Nor do most taxpayers, but most recognize that payment of taxes (even when there is disagreement with their expenditure) is the price of a civilized society.

CONCLUSION

Since (1) Congress has refused for over thirty years to pass legislation prohibiting States from using the unitary method for allocating the income of multinational corporations

and, in fact, the one time it was faced directly with the issue, refused to consent to a treaty which contained such a prohibition, and (2) this Court has consistently recognized that the unitary method is as well accepted and at least as accurate a method as the "arm's-length" method of allocating income, this Court has no basis to find that the States' use of the unitary method violates the Constitution.

The decisions of the California Courts in these cases should be affirmed.

Dated: January 19, 1994

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[illegible] United States

[illegible] Term, 1993

BARCLAYS BANK PLC,
Petitioner,

v.

FRANCHISE TAX BOARD,
An Agency of the State of California,
Respondent.

COLGATE-PALMOLIVE COMPANY,
Petitioner,

v.

FRANCHISE TAX BOARD,
An Agency of the State of California,
Respondent.

[illegible] to the Court of Appeal of the
[illegible] for the Third Appellate District

[illegible] OF THE STATE OF
[illegible] STATES OF ARKANSAS,
[illegible] MAINE AND RHODE ISLAND IN
[illegible] FRANCHISE TAX BOARD

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QUESTION PRESENTED

Whether worldwide combined reporting may be constitutional applied to foreign-based and domestic-based unitary business enterprises under this Court's dormant Commerce Clause analysis?

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Nos. 92-1384 and 92-1839

In The
Supreme Court of the United States
October Term, 1993

BARCLAYS BANK PLC,
Petitioner,
vs.
FRANCHISE TAX BOARD,
An Agency of the State of California,
Respondent.

COLGATE-PALMOLIVE COMPANY,
Petitioner,
vs.
FRANCHISE TAX BOARD,
An Agency of the State of California,
Respondent.

On Writs of Certiorari to the Court of Appeal of the State of California in and for the Third Appellate District

BRIEF OF AMICI CURIAE BY THE STATE OF NEW MEXICO AND THE STATES OF ARKANSAS, COLORADO, IDAHO, MAINE AND RHODE ISLAND IN SUPPORT OF RESPONDENT FRANCHISE TAX BOARD

INTEREST OF AMICI CURIAE

Amici are States which compute the individual tax liabilities of multijurisdictional business under the "unitary

business principle." Amici have a direct interest in the application of this Court's dormant Commerce Clause analysis to the question of what foreign source income of domestic corporate taxpayers can be considered in determining the amount of income which can be properly included in the taxpayer's apportionable tax base. This interest becomes greater each year with the continuing internationalization of the United States economy and the economy of each of the States. All of the Amici States, like California, employ accounting practices based on the formulary apportionment principle embodied in the Uniform Division of Income for Tax Purposes Act (UDITPA), 7A Uniform Laws Annotated 331 (West 1985). Many of these States include in their determination of a corporation's apportionable income interest, royalties, dividends and similar payments from that corporation's foreign subsidiaries ("foreign source" income). Taxpayers in a number of States have challenged the inclusion of this income in the apportionable bases, on the theory that the income, or the income payor, may have been subject to taxation by foreign jurisdictions under arm's-length accounting principles. *See, e.g., NCR Corporation v. Commissioner of Revenue*, 438 N.W.2d 86 (Minn. 1989), *cert. denied*, 493 U.S. 848 (1989); *NCR Corporation v. Taxation and Revenue Department of the State of New Mexico*, 856 P.2d 982 (N.M.Ct.App.1993), *cert. pending*, S.Ct. No. 93-541.

In 1983, this Court rendered a milestone decision in the area of state corporate income taxation in the case of *Container Corporation of America v. Franchise Tax Board*, 463 U.S. 159 (1983). The *Container* decision settled the jurisprudence in this area. This Court's acceptance of the petitions by Barclays and Colgate has drawn that decision into

question. A decision adverse to California in these cases would likely unsettle what are now viewed as resolved issues. Reversal of *Container* will have significant ramifications for all states which will take several decades of litigation to sort out. Amici believe that the fundamental holding of *Container* — that "foreign-source" income of a unitary business may be included in the apportioned tax base — should be affirmed.

STATEMENT PURSUANT TO RULE 37

This brief is submitted pursuant to Rule 37.3 of this Court in support of Respondent Franchise Tax Board, State of California. Consent to the filing of this brief has not been requested from the parties because the Amici filing this brief are the Attorneys General of their respective States. Rule 37.5.

SUMMARY OF ARGUMENT

The actions of the Federal Government establish that the California tax at issue in these cases is constitutionally permitted without the need for a dormant Commerce Clause analysis. Amici, nonetheless, undertake such an analysis and show that under that analytical tool the tax also passes constitutional muster.

Dormant foreign Commerce Clause analysis has six distinct elements. In the circumstances of these cases, there is no question that the taxpayers are engaged in worldwide unitary businesses and that the application of the three-factor apportionment formula has resulted in a fair and proper tax being computed. It is apparently uncontested that the first

(nexus), second (fair apportionment), and fourth (fair relationship) elements are met.

With respect to the third element of dormant Commerce Clause analysis, discrimination, Amici argue that Petitioner Barclays' claims are not complaints of discrimination but demands that they be discriminated *in favor of* because of their foreign parentage and location. There is no basis for such a claim. Foreign-based businesses have a legitimate basis to claim equal treatment, but not to claim preferential treatment.

This Court's analysis in *Container* of the fifth element of dormant Commerce Clause analysis, multiple taxation, is applicable to both foreign-based and domestic-based businesses. In the field of income taxation, the risk of multiple taxation can only be eliminated by requiring a jurisdiction to forgo taxation completely. This solution is neither proper nor required.

The final element of dormant Commerce Clause analysis, "one voice," applies to invalidate a tax only when uniformity is essential and possible foreign retaliation is justified. Neither circumstance is present in these cases. Twenty years of discussions, negotiations and agreements with the United Kingdom establish this to be true.

The California tax remains, as this Court found it in *Container*, a "proper and fair tax" and should be sustained.

ARGUMENT

THE CALIFORNIA TAX AT ISSUE IN THESE CASES MEETS ALL THE REQUIREMENTS OF THIS COURT'S DORMANT COMMERCE CLAUSE ANALYSIS

A. Introduction

No treaty to which the United States is a party, and no statutory enactment of the United States, specifically prohibits the States from using the worldwide combined report (WWCR) accounting method with respect to either domestic-based or foreign-based corporations. To the contrary, there is compelling evidence which establishes the existence of a federal policy permitting the States to use WWCR. *Wardair Canada, Inc. v. Florida Department of Revenue*, 477 U.S. 1 (1986). This policy can be drawn by implication from the body of federal law. Under these circumstances, a dormant Commerce Clause analysis is not required. Nonetheless, for purposes of argument only, Amici proceed on the premise that this Court may undertake a dormant Commerce Clause analysis to determine whether the California tax at issue in these two cases is constitutionally permissible.

The Constitution of the United States provides that the Congress shall have the power "to regulate commerce with foreign nations, and among the several states, and with the Indian tribes;" Article I, Section 8, Clause 3. "The few simple words of the Commerce Clause . . . reflected a central concern of the Framers that was an immediate reason for calling the Constitutional Convention: the conviction that in order to succeed, the new Union would have to avoid the tendencies toward economic Balkanization that had plagued

relations among the Colonies and later among the States under the Articles of Confederation." *Hughes v. Oklahoma*, 441 U.S. 322 at 325 (1979). Recognition of this principle has given rise to the view that the Commerce Clause, in the absence of evidence of specific action taken by the Federal Government to regulate commerce, nevertheless contains self-executing constraints on state action. *H.P. Hood & Sons, Inc. v. DuMond*, 336 U.S. 525 (1949); *Southern Pacific Co. v. Arizona*, 325 U.S. 761 (1945). In recognition of these self-executing constraints, this Court has developed a species of analysis commonly known as dormant Commerce Clause analysis.

The modern view of dormant Commerce Clause analysis with respect to interstate commerce was set forth in *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274 (1977), and was extended to foreign commerce, and expanded upon, in *Japan Line, Ltd v. County of Los Angeles*, 441 U.S. 434 (1979). As set forth in *Complete Auto* and *Japan Line*, the elements of a dormant Commerce Clause analysis with respect to foreign commerce are:

1) The tax must be applied to an activity with a substantial nexus with the taxing State, *Complete Auto*, 430 U.S. at 279,

2) The tax must be fairly apportioned, *Id.*,

3) The tax must not discriminate against interstate [or foreign] commerce, *Id.*,

4) The tax must be fairly related to the services provided by the State, *Id.*,

5) The tax must not give rise to an enhanced risk of multiple taxation, *Japan Line* 441 U.S. at 446, and

6) The tax must not impair federal uniformity in an area where federal uniformity is essential. *Id.* at 448.

The capstone decision applying this analysis to taxation of "foreign-source" income is *Container*.

Amici believe that the *Container* decision was correctly decided and controls with respect to the petition of the Colgate-Palmolive Company. Amici also believe that this Court's analysis of the dormant Commerce Clause requirements in *Container*, and in other cases, establishes that application of WWCR to a foreign controlled business is also constitutionally permissible. For purposes of this argument, Amici will apply the Court's dormant Commerce Clause analysis anew to Colgate and to Barclays.

B. The *Complete Auto Transit* Elements

1. Substantial Nexus

The unitary business principle is the linchpin which satisfies the requirements of nexus. *Mobil Oil Corporation v. Commissioner of Taxes*, 445 U.S. 425 (1980); *Container*. This is true for both Due Process Clause and dormant Commerce Clause purposes.

Barclays Bank Limited (Barclays) was present in California in 1977 through a wholly owned subsidiary, Barclays Bank International Limited (BBI), Stip. ¶¶ 1 and 6, BJA-9-10[1], and through a wholly owned second-tier

[1] The Joint Appendix in Barclays is referred to as BJA and the Joint Appendix in Colgate is referred to as CJA.

subsidiary, Barclays Bank of California (Barcal), Stip. ¶¶ 8 and 9, BJA-10-11. Barclays conducted a banking agency business in California, Stip. ¶ 1, BJA-9, and a commercial banking business in California, Stip. ¶ 9, BJA-11. For purposes of this litigation, BBI and Barcal agree that they were members of a worldwide unitary business, within the meaning of California law, conducted by Barclays, Stip. ¶ 27, BJA-16. The nexus element of dormant Commerce Clause analysis is satisfied.[2]

Colgate-Palmolive Company is a corporation organized and existing under the laws of Delaware, was headquartered in New York, and was qualified to do, and was doing, business in California. Stip. ¶ 1, CJA-4. Although at the trial level Colgate contested the Franchise Tax Board's determination that it was conducting a unitary business, it did not appeal the trial judge's adverse decision on this issue. Colgate is a unitary business. The nexus element of dormant Commerce Clause analysis is satisfied for Colgate as well.

2. Fairly Apportioned

In order to prove that the tax determined under an apportionment formula is unfair, the taxpayer must prove "by 'clear and cogent evidence' that the income attributed to the State is in fact 'out of all appropriate proportion to the business transacted . . . in that state,' 283 U.S., at 135, [cites omitted] or has 'led to a grossly distorted result,' [Norfolk & Western R. Co. v. State Tax Comm'n, 390 U.S. 317, 326

[2] Barclays appears to raise the question of whether this issue was decided by the lower courts, Barclays' Brief for Petitioner (Br.Pet.) 13, fn. 6. It does not appear that this has been raised on appeal here, except by Amici Government of the United Kingdom, pp. 24-27.

(1968)]." *Moorman Mfg. Co. v. Iowa*, 437 U.S. 267, at 274 (1978).

In *Container*, this Court set forth a two-fold standard by which to determine fairness: "internal consistency — that is the formula must be such that, if applied by every jurisdiction, it would result in no more than all of the unitary business' income being taxed" and "external consistency — the factor or factors used in the apportionment formula must actually reflect a reasonable sense of how income is generated." *Container*, 463 U.S. at 169. The Court has used this tool to measure the fairness of a state tax in a number of subsequent cases. *Goldberg v. Sweet*, 488 U.S. 252 (1989);[3] *American Trucking Assn., Inc. v. Scheiner*, 483 U.S. 266 (1987); *Armco Inc. v. Hardesty*, 467 U.S. 638 (1984).

California, during the years in issue, followed the UDITPA and used the three-factor apportionment formula contained in the Act for Colgate and used a modified three-factor apportionment formula for Barclays.[4] The use of the three-factor formula was approved by this Court in *Butler Bros. v. McColgan*, 315 U.S. 501 (1942), and is now referred to by the Court as "something of a benchmark against which other apportionment formulas are judged." *Container* 463 U.S. at 170, *Amerada Hess Corporation v. Division of*

[3] The definition of "external consistency" was worded differently in *Goldberg v. Sweet* where the Court phrased it as "ask[ing] whether the State has taxed only that portion of the revenues from the interstate activity which reasonably reflects the in-state component of the activity being taxed." 488 at 262. The difference in wording would appear to have no impact on these cases.

[4] The three-factor formula used by California for banks and financials includes intangible property in the measure of the property factor.

Taxation, 490 U.S. 66 at 73 (1989). UDITPA's apportionment formula is both internally and externally consistent.

During the course of the trial in this matter, counsel for Barclays advised the trial judge that Barclays was not arguing that the taxes were unfairly apportioned. BJA-832-833. The fair apportionment element of dormant Commerce Clause analysis is not at issue in that case.

At the trial level, Colgate argued that application of WWCR distorted the amount of income attributed to California. The trial judge found against Colgate on this issue, and the decision was sustained by the appellate court which held that Colgate had not met the steep burden of demonstrating an unconstitutional distortion of its liability determined through the use of WWCR and that the tax was fairly apportioned. Colgate Petition, Appendix E, pp. 66a-71a. Colgate did not contest the state court decision in its petition to this Court.

3. Discrimination

This Court has held that a tax may violate the Commerce Clause if it is facially discriminatory, has a discriminatory intent, or has the effect of unduly burdening interstate commerce. *Amerada Hess* 490 U.S. at 75.

There is no discrimination on the face of the California statute and neither taxpayer claims that the statute on its face treats in-state and out-of-state businesses differently to the disadvantage of the out-of-state business. There is also no discriminatory intent manifested in the California law, and the taxpayers do not claim that the California tax was intended to give an advantage to local industry.

The only argument offered regarding discrimination is made by Barclays, which argues that the effect of the California tax is discriminatory because it creates undue, "prohibitive," burdens on foreign-based multinational businesses in order to file a California return using WWCR. Petitioner Colgate's argument is even simpler. It is the "What if?" argument. Colgate argues that if this Court were to find in favor of Barclays, regardless of the reason, it would then be discriminatory to tax Colgate under a different taxing scheme.

Stated in its simplest terms, Petitioner Barclays is requesting special treatment because they are foreign-based businesses which voluntarily entered the California market. The Constitution of the United States, the treaties entered into by the United States,[5] and the statutes of the United States do not require that foreign-based businesses be given dispensations so that they may operate at a competitive advantage as compared to United States-based businesses. *Sumitomo Shoji American, Inc. v. Avagliano*, 457 U.S. 176 (1982). A foreign-based business must pay its way, and it is reasonable for a tax authority to require a foreign corporation to present its tax information in a manner which complies with the requirements of the tax authority as long as they do not disadvantage the foreign entity. There is no credible evidence that California's filing requirements cause an undue burden on Barclays. California's rules regarding the preparation of combined reports involving worldwide activities are before

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[5] Barclays' counsel at trial stated that it was not claiming that it had been discriminated against in terms of the protections offered by the United States/United Kingdom Tax Convention. Reporter's Transcript (RT) 1815-1824, BJA-837-840.

this Court, Ex. 12, BJA 50-57, and, therefore, this Court should not be misled by the exaggerated and inaccurate claims made by Barclays and its amici.

First, under California law, it is not necessary for Barclays to set up a second and separate system of accounting. Barclays may use statements it regularly prepares for its own purposes with adjustments to these statements, *if material*, BJA-54, (b)(3)(C), to reconcile differences between foreign and United States GAAP and California tax accounting standards. See Regulation § 25137-6, BJA-50, (b)(A), and BJA-51, (b)(2). Moreover, Barclays had prepared United States GAAP statements for other purposes. Stip. ¶ 51 and Ex. 51G, BJA-40.

Second, Barclays does not have to maintain its records in United States dollars and in English. Regulation § 25137-6 provides that the calculation of income, BJA-51, (b)(1)(D) and (b)(2), and the apportionment factors, BJA-55, (c)(1)(E), and BJA-56, (c)(2)(C), are to be made in the currency of the parent company. In any event, the language in which the consolidated records of Barclays are maintained is English.

Third, Barclays presses the argument that hypothetical costs of compliance in the millions of dollars creates an undue burden and thereby establishes a basis for discrimination which they characterized as "economic protectionism." (Br.Pet. p. 44, fn. 13.) The California appellate court found that the real cost of compliance, as evidenced by the bills from a major accounting firm for preparing the WWCR returns filed by BBI, was $900 to $1,250 annually. Appendix to the Petition, D-19, fn. 9. These returns were acceptable to California except as to the scope of the unitary business. This

Court should defer to the judgment of the California courts as to what level of detail, specificity and documentation is sufficient for California tax filings. This is not the stuff of discrimination.

Fourth, foreign-based businesses do not file on a different basis under Regulation § 25137-6 than do domestic-based businesses, and therefore, the foreign-based businesses need not forgo tax benefits. Barclays' argument is based on the unfounded assumption that a domestic-based business maintains its records in a form which corresponds to the filing requirements of California. The reasons for a domestic-based corporation to maintain records which conform to the requirements of the California Revenue and Taxation Code are the same as they are for a foreign-based corporation: to file California tax returns. There is no other reason. To the extent a separate set of records or schedules is required for a domestic-based business, it is required for a foreign-based business. To the extent a domestic-based business can use estimates and approximations, a foreign-based business may. There is no discrimination. Barclays was treated in the same way every other taxpayer was treated. BJA-831-832.

Finally, Barclays wrongly claims discrimination because it must comply with WWCR in California but domestic-based businesses do not have to comply with WWCR in any foreign country. There is no evidence in the record as to what tax and information requirements domestic-based multinationals are subject to in foreign countries. Without that evidence, Barclays' claim is without support. More importantly, this argument is based on a faulty comparison. The relevant point of comparison for the purposes of the United States Constitution is what *California* requires of domestic-based

unitary businesses versus what it requires of foreign-based unitary businesses. It requires the same method of filing, WWCR, and the same information; therefore, there is no discrimination. In *Container*, this Court, held that the States' use of formulary apportionment need not yield to the arm's-length accounting methods favored overseas. 463 U.S. at 193.

In considering the discrimination arguments raised in these cases, this Court is presented with a blueprint of the consequences if it accepts them. First, Barclays claims discrimination because it is foreign. It advances a number of reasons why its place of organization justifies separate treatment. If this Court accepts Petitioner Barclays' argument, and concludes there is discrimination, then it must face a second claim of discrimination by domestic-based multinationals.

Petitioner Colgate is dependent upon Barclays winning its case. If Barclays does not win, then how can Colgate win? If Barclays is successful, then Colgate argues, as did the dissent in *Container*, 463 U.S. at 197-205, that it is being discriminated against vis-à-vis foreign-based multinationals. Colgate's argument, if accepted, requires that *Container* must be overruled.

The unraveling of the fabric of this Court's analysis continues when Colgate's logic is extended to the unitary business which conducts all or part of its foreign activities through a domestic corporation, or a unitary business which functions through a single corporation, foreign or domestic. Colgate's preferential treatment in these circumstances will again open the door for further claims of discrimination and

the overruling of a series of cases including *Bass, Ratcliff & Gretton, Ltd.*, 266 U.S. 271 (1924), and *Mobil Oil*, 445 U.S. 425. In fact, the consequences may ultimately lead to another revisitation of the unitary business principle as this Court did two terms ago in *Allied-Signal, Inc. v. Director, Division of Taxation*, 504 U.S. ___, 119 L.Ed.2d 533 (1992).

Any differences in compliance costs between domestic-based and foreign-based multinationals argued by Barclays and Colgate are purely hypothetical, not actual, and arise from an improper comparison of taxpayers who are not similarly situated. *Kraft General Foods v. Iowa Dept. of Revenue and Finance*, 504 U.S. ___, 120 L.Ed.2d 59, fn. 23 (1992). By characterizing these hypothetical differences as discrimination, Barclays invites this Court to take a first step on a slippery slope. Barclays has been treated in a nondiscriminatory manner, and the California tax should be affirmed. The question of compliance requirements for similarly situated taxpayers is appropriately left to the legislative branch of government, either state or national, so long as they are fairly applied, as they are here.

4. Fairly Related to Services Provided

The requirements of this element of dormant Commerce Clause analysis are satisfied by the provision of such state services as "police and fire protection, the benefit of a trained work force and 'the advantages of a civilized society.'" *Exxon Corporation v. Wisconsin*, 447 U.S. 207, at 228 (1980). There can be no doubt that both Barclays and Colgate enjoy these basic California benefits and neither petitioner has

presented any evidence with respect to this issue.[6] It is not properly before this Court.

C. The *Japan Line* Elements

This Court's recent comments on the interrelationship between the four elements of the *Complete Auto Transit* analysis and the two *Japan Line* elements should be noted prior to proceeding to an examination of the other two elements of dormant foreign Commerce Clause analysis:

> [C]ompliance with the Complete Auto test has relevance to our conclusion that the state tax meets those inquiries unique to the foreign commerce clause. That the tax is a fair measure of the State's contacts with a given commercial transaction in all four aspects of the Complete Auto test confirms both the State's legitimate interest in taxing the transaction and the absence of an attempt to interfere with the free flow of commerce, be it foreign or domestic. *Itel Containers International Corporation v. Huddleston*, 507 U.S. ___, 122 L.Ed.2d 421, at 436 (1993).

1. Multiple Taxation

In *Japan Line*, this Court first enunciated the "enhanced risk of multiple taxation" element of dormant foreign Commerce Clause analysis. *Japan Line* involved the imposition of a property tax. With respect to property taxes, this Court found that pursuant to the custom of nations, Japan, the country of domicile of the owner of the containers, had asserted property taxes on the full value of the containers (441

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[6] **Barclays in its petition raises the question as to whether this issue was ruled upon by the trial court. Br.Pet. 13, fn. 6.**

U.S. at 454) and therefore the assertion of a tax by Los Angeles would inevitably result in actual multiple taxation (441 U.S. at 455). This Court has had the opportunity to explicate the multiple taxation element of dormant Commerce Clause analysis in subsequent cases.

In *Mobil Oil*, this Court distinguished *Japan Line* as follows:

> That case [Japan Line] involved ad valorem property taxes assessed directly upon instrumentalities of foreign commerce. . . . the factors favoring use of the allocation method in property taxation [taxation in full by the state of domicile] have no immediate application to an income tax. . . . Finally, in Japan Line the Court was confronted with actual multiple taxation that could be remedied only by adoption of an allocation approach. . . . in the present case we are not similarly impelled." 445 U.S. at 448.

In *Itel Containers International Corporation v. Huddleston*, this Court said:

> [T]he foreign commerce clause cannot be interpreted to demand that a state refrain from taxing any business transaction that is also potentially subject to taxation by a foreign sovereign. "Japan Line does not require forbearance so extreme or so one-sided." *Container* [citations omitted] . . . Absent a conflict with a "consistent international practice [or] . . . federal policy" *Container* [citations omitted], the careful apportionment of a state tax on business transactions conducted within state borders does not create the substantial risk of international multiple taxation that implicates foreign commerce clause concerns. 507 U.S.___, 122 L.Ed.2d at 436-437 (1993).

The most thorough explication of the *Japan Line* multiple tax analysis, and the one most directly applicable to the circumstances of these cases, was provided in *Container*, 463 U.S. at 187-193. In *Container*, this Court considered the very method of taxation involved in the present cases and held that what it characterized as actual double taxation was not unconstitutional. In *Container*, 463 U.S. at 187-189, this Court noted four similarities between the circumstances in that case and in *Japan Line*: 1) actual double taxation, 2) a serious divergence in the taxing scheme of California and foreign authorities, 3) a foreign practice consistent with international practice, and 4) a preference for the internationally accepted method by the federal government for purposes of its tax. This Court further noted three differences between the circumstances of *Japan Line* and *Container*: 1) the tax was an income tax not a property tax, 2) the double taxation was not inevitable, and 3) the tax fell not on the foreign owners of an instrument of commerce but on a corporation domiciled and headquartered in the United States. This Court then analyzed the distinctions and determined they constituted a constitutionally significant difference, 463 U.S. at 189. This Court's analysis directs a similar conclusion in these cases.

Colgate and *Container* are identical. The same three distinctions are applicable. Once again, California could achieve the elimination of all double taxation only by deferring to the taxation decisions and income allocation methods made by every other nation. In spite of "double taxation [being] a constitutionally disfavored state of affairs . . . [our analysis] does not require forbearance [by the States] so extreme or one-sided." *Container*, 463 U.S. at 193.

In the circumstances of Barclays, the first two distinctions apply, regardless of the parentage. The tax involved is an income tax where division of the base is the norm, it is not a property tax, and multiple taxation is not automatic.

The clarity and significance of the third distinction is more difficult to determine. In Barclays we have two taxpayers: the first is a California corporation owned by a foreign parent, and the second is a foreign incorporated entity doing business in California.[7] The facts of this case demonstrate that no significance should be attached to ownership. First, the taxpayers are amenable to being taxed in some manner. Second, the only manner of avoiding any complaints is to forgo taxation completely or to have it dictated by the foreign countries. Third, almost seventy years ago this Court accepted the proposition that a foreign-country-domiciled taxpayer could have its State income determined under a formulary method. *Bass, Ratcliff & Gretton, Ltd v. State Tax Commission*, 266 U.S. 271 (1924). No circumstances are presented in this case which justify this Court abandoning this long-established precedent.

2. One Voice

As an initial matter, this analysis must start with the admonition of this Court that "Absent some explicit directive from Congress, we cannot infer that treatment of foreign income at the federal level mandates identical treatment by the States." *Mobil Oil*, 445 U.S. at 448. In light of this

[7] In *Container*, this Court noted that a different level of significance might attach to the incident of the tax when the taxpayer was owned by foreign interests. The Court did not determine whether this would be analytically significant. 463 U.S. at 195, fn. 32.

admonition, the fact that the Federal Government uses the arm's-length method does not automatically require the States do so.

The Executive and Legislative branches have determined that this is not an area where it is *essential* for the Federal Government to speak with one voice. Their judgment has proven correct.

Japan Line stated that an element of the dormant Commerce Clause test is whether the state tax "may impair uniformity in an area where federal uniformity is essential." 441 U.S. at 448. The determination of whether a particular area is one where uniformity is *essential* must in the first instance be a determination to be made by the Legislative Branch which is vested by the United States Constitution with the authority to regulate Commerce. (U.S. Const., art. I, § 8, cl. 3.) As this Court has recognized, it "has little competence in determining precisely when foreign nations will be offended by particular acts, and even less competence in deciding how to balance a particular risk of retaliation against the sovereign right of the United States as a whole to let the States tax as they please." *Container*, 463 U.S. at 194.

The determination that this is an area where uniformity is not essential has been made by the Congress as evidenced by 1) the action of the United States Senate in refusing to give its advice and consent to a United States/United Kingdom Tax Convention containing a restriction on state taxation specifically intended to prohibit the tax here at issue, Ex. 36C, BJA-238 and Ex. 36D, BJA-311, 2) the Senate's approval of treaties containing no limitation on the States' use of WWCR both in conjunction with, and subsequent to, the United

States/United Kingdom Tax Convention, Stip. ¶ 40, BJA-26-31, and 3) Congressional failure to enact numerous bills which would have prohibited the State tax here at issue, Stip. ¶ 38, BJA-24-25. Of particular significance in the latter regard are the bills which were introduced and considered after the Senate's rejection of the United States/United Kingdom Tax Convention. There could be no doubt what was at stake with respect to those bills, yet no action was taken. Even if the Court is unwilling to consider these actions as an affirmative act of the Congress which would completely preempt a dormant Commerce Clause analysis (see *Western and Southern Life Insurance Company v. State Board of Equalization*, 451 U.S. 648 (1981)), they are, nonetheless, sufficient to establish a Congressional determination that this is an area where federal uniformity is not essential.

Further evidence of the determination that this is an area where federal uniformity is not essential is supplied by the actions of the Executive Branch in years subsequent to the Senate's rejection of the United States/United Kingdom Tax Convention by its request for voluntary state action, its withdrawal of support for a federal legislative solution, Ex. 37I, BJA-439, and its determination that this Court need not consider the petition filed by Barclays in the instant case. Brief of United States, October 7, 1993.

This Court's one-voice analysis in *Container* also took into consideration whether a state tax "might *justifiably* lead to significant foreign retaliation." (Emphasis added.) 463 U.S. at 194. Retaliation in unlikely here. The treaty negotiated between the United Kingdom and the United States, as ultimately approved by the Senate, does not prohibit the tax here at issue. Ex 36D, BJA 393-394. In fact, the United

Kingdom and the United States negotiated additional concessions as the result of the Senate's refusal to give its advice and consent to the restriction the UK sought. Third Protocol to the Treaty, Ex 37H, BJA-436. Finally any retaliation of the sort the British have threatened has been recognized by the Executive Branch as a violation of the treaty now in effect. Testimony of Roger Mentz, Ex 37I, BJA 439 at 443.

In *Container*, this Court was faced with having to determine whether the state tax could interfere with United States foreign policy without the benefit of a fully developed history such as is present in this case. To assist in its determination, this Court made reference to three "objective standards that reflect very general observations about the imperatives of international trade and international relations." 463 U.S. at 194.[8] In the circumstances of these cases, there is no need for this Court to engage in this complex, technical and somewhat speculative analysis because other facts and circumstances have established that uniformity is not essential. More importantly, several United States Senators have filed an *amicus* brief in support of California in this case requesting that this Court leave complex foreign policy analyses to the Senate.

[8] For example, this Court in *Japan Line*, 441 U.S. at 453, discussed the "asymmetry" of California's tax. There "asymmetry" referred to the fact that Japan did not tax American containers at all, while Los Angeles County wished to tax Japanese containers in part. Petitioner Barclays reads this to mean that because it believes no other jurisdiction, other than a State, uses WWCR there is "automatic asymmetry." Br.Pet. pp. 28-29. If Barclays' definition were correct, then "automatic asymmetry" would exist in *Container*, but this Court found it did not. 463 U.S. at 194-195. Therefore, Barclays' interpretation of "automatic asymmetry" is incorrect.

D. Consistency is Very Important in State Taxation

This Court's decision in *Container* has been the rule of law for over ten years. Congress has certainly had the power to change the result of that decision and has not done so. Overturning the *Container* decision would almost certainly impact the taxation of multinational corporations by the vast majority of the States that use the formulary apportionment principles of UDITPA.[9] *See Moorman Mfg. Co.*, 437 U.S. at 283, fn. 1 (Powell, J. diss.). Each of these States that utilize UDITPA to apportion income has relied on and applied *Container* to the thousands of corporations with multinational income doing business in their States. With multi-year refunds available, a reversal of *Container* will result in a tremendous assault on the States' current revenues. *See Harper v. Commonwealth of Virginia*, 507 U.S.___ , 125 L.Ed.2d 74 (1993).

Therefore, while California's taxing system passes every element of dormant Commerce Clause analysis, the taxes can and should be upheld by this Court also on the basis of *stare decisis*. In *Quill Corporation v. North Dakota*, 504 U.S. ___, 119 L.Ed.2d 91 (1992), this Court offered the following comments with respect to its Commerce Clause-based cases:

> [T]he Bellas Hess rule appears artificial at its edges: . . . This artificiality, however, is more than offset by the benefits of a clear rule. Such a rule firmly establishes the boundaries of legitimate state authority. . . . This benefit is important, for as we have so frequently noted, our law in this area is something of a "quagmire" and the

[9] Forty-five of fifty states (all which assert taxes on or measured by income) use some form of apportionment.

"application of constitutional principles to specific state statutes leaves much room for controversy and confusion and little in the way of precise guides to the States in the exercise of their indispensable power of taxation." Northwestern States Portland Cement Co. v. Minnesota [cites omitted].

. . . [A] bright-line rule . . . encourages settled expectations and, in doing so, fosters investment by business and individuals. 119 L.Ed.2d at 109.

CONCLUSION

The "proper and fair method of taxation," *Container*, 463 U.S. at 184, used by California in these cases passes all elements of a dormant Commerce Clause analysis and is a constitutional exercise of California's sovereign power to tax. The judgments of the California courts should be affirmed.

Dated: January 19, 1994

Respectfully submitted,

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Nos. 92-1384 and 92-1839

In The
Supreme Court of the United States
October Term, 1993

BARCLAYS BANK PLC,
Petitioner,
vs.
FRANCHISE TAX BOARD,
An Agency of the State of California,
Respondent.

COLGATE-PALMOLIVE COMPANY,
Petitioner,
vs.
FRANCHISE TAX BOARD,
An Agency of the State of California,
Respondent.

On Writs of Certiorari to the Court of Appeal of the State of California in and for the Third Appellate District

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BRIEF OF AMICI CURIAE IN SUPPORT OF RESPONDENT FRANCHISE TAX BOARD BY THE CALIFORNIA TAX REFORM ASSOCIATION AND CALIFORNIA TEACHERS ASSOCIATION; CALIFORNIA FEDERATION OF TEACHERS;
(Continued on inside cover)

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QUESTIONS PRESENTED

1. Whether a political decision by California's citizens to impose an effective, nondiscriminatory corporate income tax to fund public services which support and encourage international trade should be reversed as an undue burden under the Commerce Clause?

2. Whether the Court should ignore the treaty process to make new foreign policy, nullifying State budget and tax laws, in the absence of clear and convincing proof that the State tax is too burdensome or discriminatory?

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BRIEF OF AMICI CURIAE IN SUPPORT OF RESPONDENT FRANCHISE TAX BOARD BY THE CALIFORNIA TAX REFORM ASSOCIATION AND CALIFORNIA TEACHERS ASSOCIATION; CALIFORNIA FEDERATION OF TEACHERS; CALIFORNIA FACULTY ASSOCIATION; CALIFORNIA SCHOOL EMPLOYEES ASSOCIATION; CALIFORNIA STATE EMPLOYEES ASSOCIATION; CALIFORNIA STATE COUNCIL OF SERVICE EMPLOYEES; CALIFORNIA PROFESSIONAL FIREFIGHTERS; AMERICAN FEDERATION OF STATE, COUNTY, AND MUNICIPAL EMPLOYEES;

BUILDING AND CONSTRUCTION TRADES COUNCIL OF CALIFORNIA; CALIFORNIA STATE COUNCIL OF CARPENTERS; AND CALIFORNIA INDEPENDENT PUBLIC EMPLOYEES COUNCIL

INTEREST OF *AMICI* [1]

The California Tax Reform Association is a California nonprofit organization which represents the interests of the citizens of California in sound tax policy. It was incorporated in 1977 with the support of a coalition of citizens groups. It is supported through public contributions and foundation grants. The Association has participated in the legislative process and litigation about California's use of the unitary accounting method to allocate profit for the past 15 years. It is uniquely able to present arguments on the issues before this Court from the perspective of the California citizen/taxpayer.

Other *amici* are unions and associations which represent both public sector and private sector employees who are part of California's work force. The members of these organizations are the individual taxpayers who will have to bear the direct cost of either additional taxes or lost services if the Petitioners are successful in their pleas to this Court. These *amici*, and the individuals which they represent, have a direct and immediate concern in the outcome of these cases.

SUMMARY OF ARGUMENT

Arguments advanced by Barclays and its *amici*, characterizing California's tax as burdensome, ignore the facts. California law, regulations and the supporting regulatory and administrative decisions deal simply, and directly, with the fictitious "chamber of horrors" advanced in their briefs.

[1] Pursuant to Rule 37, consent of the parties has been requested and obtained. Copies of the written consents will be filed under separate cover.

California's worldwide combined reporting system (WWCR) enhances, rather than burdens, international trade. The California corporate tax, including WWCR, is an essential element of a successful State policy to enhance international trade and commerce.

The decision to tax all corporations doing business in California on a worldwide combined basis was part of a conscious policy by the citizens of California to develop international trade and foreign investment through public spending on education, training and physical infrastructure. Tax revenue from multinational corporations was an essential element of the plan. To be successful, the tax had to maintain a level playing field for all competitors, whether wholly domestic or multinational.

The investment decisions and the tax policy paid off handsomely. California became a favored site for high technology industry. Foreign investment soared, imports and exports soared. The economy of California became larger than that of most sovereign nations. California's effective taxation of all corporations provided a significant portion of the revenue essential to support this growth and development. It also provided a level playing field for wholly domestic competitors.

The history of public investment in support of foreign trade and the resulting pattern of spectacular growth in foreign trade and investment is inconsistent with the argument that the tax is an undue burden on international commerce.

The foreign policy powers of the United States are delicately balanced between the Executive and the Congress.

The Executive has the broad power to act on diplomatic matters. The right to make treaties, however, is sharply limited by the ratification process. To become the supreme law of the land, a treaty must be ratified by a two-thirds vote of the Senate. The Senate has debated and explicitly rejected a treaty which would have changed California's WWCR system, and the Executive Branch acquiesced to that rejection.

Having failed at the constitutional process, multinational corporations and foreign governments now ask this Court to take over the role of arbiter of foreign policy in the international tax arena and nullify California law. But there should be no federal preemption of State law, absent legislation or a treaty. The Commerce Clause does not protect foreign corporations from paying nondiscriminatory State taxes.

I. THERE IS NO CREDIBLE EVIDENCE THAT CALIFORNIA'S TAX ACCOUNTING METHOD BURDENS FOREIGN COMMERCE.

A. The Claimed Million Dollar Costs of Compliance Are An International Red Herring.

Barclays, and a number of its *amici*,[2] argue that either compliance with WWCR is virtually impossible or so expensive for foreign-based multinationals as to constitute discriminatory treatment. They claim international businesses do not otherwise keep the data required for WWCR. Their assertions are not correct.

[2] See Briefs of Reuters Limited, Confederation of British Industry, Council of Netherlands Industrial Federations, Federation of German Industries and the Association of German Chambers of Industry and Commerce, Japan Tax Association and Banque Nationale De Paris.

A WWCR calculation requires just seven basic numbers: 1) worldwide income, 2-4) worldwide property, payroll and sales, and 5-7) California property, payroll and sales.[3] Jerome Hellerstein, a venerated authority on state taxation, noted:

> The fact is that much of the data required for formulary apportionment already are being gathered by multinationals for business, financial and reporting purposes, for tax returns, and for SEC and other regulatory agency filings. Foreign currency transactions must be converted into dollar figures for such purposes. Furthermore, with the increasing globalization of industry and of the worldwide accounting firms that service multinational enterprises, and the computerization of accounting records, compliance with apportionment requirements on a worldwide basis is not the formidable task it once was. *Federal Income Taxation of Multinationals: Replacement of Separate Accounting with Formulary Apportionment*, Tax Notes, August 23, 1993, at 1142.[4]

Barclays' and its *amici*'s arguments also fail when their claims are compared to the text of the California regulation,

[3] The source of such numbers for the Barclays Group is in the record. See Exs. 51E, 51F, 51G, 51K, 51Q, 51R, 51S, and 51U. Respondent's expert witness, John Shank, in his testimony at trial, illustrated how various exhibits could be used to construct a WWCR. Reporter's Transcript 2039-2097.

[4] For additional comments on the compliance arguments, see Benjamin F. Miller, *A Reply to "From the Frying Pan to the Fire,"* State Tax Notes, September 27, 1993, p. 705.

§ 25137-6.[5] Barclays Joint Appendix (BJA) Ex. 12, BJA-50-57.

1. Separate books are not needed.

First, the claim is made that a separate set of books and records, stated in California accounting terms, must be established. For example, the *amicus* brief of the Confederation of British Industry at page 14 states:

> Thus, in practical terms, to comply fully with worldwide combined reporting a foreign multinational would have to keep a separate set of books for each foreign corporation using the accounting rules of each WWCR jurisdiction in which any member of the group operates.

Barclays and Reuters merely imply that a separate set of books is required. Reuters at p. 3, states:

> It is the international norm that a multinational enterprise keep all of its books and records in conformance with the requirements of its home country. It is *not* the international norm that a multinational enterprise keep *all* of its books and records in accordance with the tax and accounting requirements of *every* country in which it does business. (Emphasis in original.)

They create the impression, without saying so directly, that WWCR requires a separate set of books and records. The care Reuters and Barclays show in their briefs is understandable. Both have direct filing experience with the States: Barclays with California, and Reuters with New York.

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[5] The California regulation is an adaptation of 26 C.F.R. §1.964-1. If Petitioner Barclays' allegations that the California regulation violates the Due Process Clause because of vagueness and the lack of reviewable standards are accepted, then the federal regulation apparently is also invalid.

In Barclays' case, the California courts found that the actual cost of compliance, for a worldwide combined report for Barclays Bank International, as evidenced by the bills it received from a major accounting firm, was $900 to $1,250 annually.[6] The returns were acceptable to California except as to the scope of the unitary business.

Reuters, a United Kingdom corporation, filed returns with New York State on an apportioned basis for decades before their sudden assertion that the returns would cost in excess of a million dollars annually to prepare.[7] The New York courts found Reuters' claim disingenuous, based on their prior filing experience and the fact that they were able to file their "million dollar" return within ten days of learning that New York was going to require them to file. *Reuters Ltd. v. Tax Appeals Tribunal*, No. 186, slip op. New York Court of Appeals (N.Y. Oct 12, 1993).

California's regulation does not require that separate books and records be maintained. Regulation § 25137-6, as its starting point, uses either "a profit and loss statement prepared for each foreign branch or corporation in the currency in which the books of account of the branch or corporation are regularly maintained," Ex. 12, BJA-50, (b)(1)(A), or "the consolidated profit and loss statement prepared for the related corporations . . . for filing with the Securities and Exchange Commission . . . [or] for reporting to shareholders. . . ." BJA-51, (b)(2). Adjustments are then made to these statements, if material, BJA-54, (b)(3)(C), for differences between foreign and United States Generally Accepted

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[6] Appendix to the Petition, D-19, fn. 9.

[7] Affidavit of Michael J. Canty, Financial Manager — Taxation of Reuters, Ltd., submitted as evidence in the New York matter.

Accounting Principles (GAAP) and California tax accounting standards. A second and separate system is not required, nor even suggested.

2. The accounts need not be in English or in dollars.

The claim is made that the accounts must be kept in dollars and in English.[8] This is incorrect. Regulation § 25137-6 provides that the calculation of income, Ex. 12, BJA-51, (b)(1)(D) and (b)(2), and the apportionment factors, BJA-55, (c)(1)(E), and BJA-56, (c)(2)(C), are to be made in the currency of the parent company. There is no requirement about which language a reporting firm must use in its accounting records. Use of the language of the parent company is implicitly acceptable. In any event, the consolidated accounting records of Barclays are maintained in English.

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[8] "Reports also must be in English and in U.S. dollars." *Amicus* brief of Confederation of British Industry, p. 12.

"[A] foreign based multinational corporation will not ordinarily have to restate its accounts in accordance with the accounting principles of the United States or one of its states, nor need to translate its accounts into U.S. dollars or all its records in English. WWCR requires such restatement and translation, . . ." *Amicus* Brief of Council of Netherlands Industrial Federations, p. 5-6.

"WWCR requires corporate taxpayers to provide details of taxable income for worldwide operations translated into English and adjusted to U.S. and even specific state taxation accounting principles and U.S. currency." Amici brief of Federation of German Industries and Association of German Chambers of Industry and Commerce, p. 7.

Barclays also suggests, that in order to file under WWCR, it must maintain its records in United States dollars and in English. Barclays Opening Brief, p. 44.

3. Conforming foreign financial statements to the United States Generally Accepted Accounting Principles (GAAP) are routinely required.

The claim is made that a United States GAAP conversion is not routinely made for other purposes.[9] These claims are false. First, there is no requirement that accounting records be maintained in accordance with United States GAAP. There is, however, a requirement to convert the regularly maintained records to United States GAAP. But adjustments are to be made only if material. Ex. 12, BJA-54, (b)(3)(C). If the adjustments are not material, they do not have to be made.

Further, U.S. GAAP statements are required for companies which trade on United States security exchanges. In this case, Barclays had, in fact, prepared United States GAAP statements for other purposes. It prepared a prospectus that was used to market its securities here. Stip. ¶ 51 and Ex. 51G, BJA-40. Examination of the Barclays prospectus shows only five material differences between U.S. GAAP financials and the United Kingdom version. Furthermore, trial testimony, by Barclays' own expert witness, established that of the GAAP differences identified, only one had significance for California tax purposes and that the information for the adjustment was readily available. RT 1004-1012. U.S. GAAP statements are also frequently required of foreign-based businesses by United States banks as a condition of getting a loan.

It should also be noted that following the Bank of Credit and Commerce International scandal, state and federal bank regulators have tightened the reporting and accounting requirements for international banks seeking to do business in

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[9] See footnote 8.

the United States. Banks must show their sources of capital and the full financial structure of their affiliated companies. These requirements far exceed the requirements California imposes in connection with its tax returns. See, The Foreign Bank Supervision Enhancement Act of 1991, P.L. 102-42, Title 2, Subtitle A.

4. WWCR fairly allocates bank profits.

One *amicus*, Banque National De Paris, hereinafter Banque, claims that currency exchange accounting problems arise under California WWCR. Banque's claim ignores the fact that the California regulation recognizes the difference between domestic and foreign companies by allowing each of them to determine income and exchange factors in the currency of the parent company.

Banque complains, pp.7-10, that a United States bank and a French bank will have different profits and losses, as expressed in dollars, when the United States bank makes a loan in dollars and the French bank makes a loan in francs because the relative values of the franc and dollar change over time. The assertion is correct, but the conclusion drawn from it is wrong. Their incomes are different. The French bank calculates its income in francs, and the United States bank calculates its income in dollars. The French bank will be taxed fairly under California's regulations because it will report its profitability in the currency of the French parent, the French franc.

For example, if a United States bank makes a franc loan, there are two calculations which must be made to determine income. First, there is the interest and fee profit on the loan itself. Second, there is the profit or loss on the foreign exchange transaction when the bank makes the French franc loan. That will be determined when the loan is repaid. Similarly, a French bank which makes a dollar loan also has

an exchange transaction to account for in determining income. Not surprisingly, the exchange transactions will yield a different result for each bank during the same period. If the dollar strengthens, the United States bank has an exchange loss on lending francs and the French bank has an exchange gain on lending dollars. As long as both transactions are accounted for in the currency of the parent, the net result will be equivalent.

Banque cites two compliance concerns, pp. 4-6. The first is a contrived example involving California's bad debt rules. Under California law, banks and financials are allowed to take a deduction under either the specific charge-off method (a loss is taken when a loan is written off) or under the reserve method (past experience is used to estimate future losses, and a loss is allowed even though it is not yet incurred). In neither circumstance is the accounting particularly complex.[10] The specific charge-off speaks for itself, and the reserve method merely uses past charge-offs to predict future experience. The experience factor for California purposes is based on either three or six years' of experience. Banque complains about neither of these methods. Its example is based upon a facts-and-circumstances exception which allows for a deduction for more than past experience would allow if present circumstances indicate it is appropriate. Furthermore, the procedure discussed is not the only means of establishing the need for an additional reserve but merely one method of showing the need for an additional deduction.

Banque's second compliance concern deals with the establishment of historic cost of fixed assets (the reference to

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[10] In point of fact, Barclays uses the reserve method for accounting for bad debts for its financial reporting purposes based upon five years' of experience. Ex. 51E, p. 29.

financial assets appears to be included for purposes of obfuscation rather than relevance). Banque's complaint is based upon the assumption that foreign multinationals do not keep consolidated books and records prepared in a manner similar to that used in the United States. Whatever the case may be with Banque, it is not the case with Barclays. Barclays' published financial statements allow for the determination of the value of fixed assets at historic cost expressed in Sterling.[11]

Banque's other complaints are equally contrived. For example, the three elements of disproportionality on pages 11-12 of Banque's brief assume the United States tail will wag the foreign dog because they assume that all the calculations must be done in dollars. Banque ignores the fact that the California regulation provides for factor and income calculations to be made in the currency of the parent company. The primary reason for this approach was to look at the entire corporation fairly from the perspective of its home country.

WWCR will give a much fairer picture of a bank's California profit precisely because it ignores the details of the individual transactions and looks for a fair apportionment of the overall result. If California were to use the transactional system, it would be mired in the same arguments Banque raises in its brief. In that case, the bank's arguments would

[11] United Kingdom GAAP allows for the revaluation of fixed assets. Barclays has taken advantage of this treatment. When assets are revalued, a reserve is established as a Note to the Financial Statements which includes the amount of the revaluation. See Ex. 51E. This reserve can then be used to adjust balance sheet values back to original cost and to adjust depreciation for income statement purposes. Testimony of Bernard Caldwell (expert witness called by Barclays), RT-1012.

be used to explain, transaction by transaction, why there was no income in California.

WWCR limits the need for time-consuming and expensive audits to determine income. This facilitates trade, it does not limit it.

B. The "Burdens" Imposed Upon Corporate Taxpayers Have Allowed California To Attract Foreign Investment.

1. California has attracted international investment.

If California were a separate country, its economy would be the seventh largest in the world. It has a diverse regional economy, characterized by advanced technological capabilities, a vast and expanding international market and, until recently, rapid rates of economic growth. Among States and regions of the United States, it has among the highest levels of integration with the world economy; it leads the nation in exports as a percentage of its gross domestic product[12] and in direct foreign investment.[13] In fact, the extent of the internationalization of the California economy is far greater than that of the U.S. as a whole. Thus, in terms of public policy adaptation to the growing internationalization of the economy, California's economy is on the cutting edge.

Another feature of California's economy has been its high rate of public sector investment. Rapid economic growth has been accompanied by public investment in universities and schools, highways and mass transit, water projects and parks,

[12] *Foreign Direct Investment in California*, a joint report of California's Trade and Commerce Agency, the Office of Foreign Investment, and the Office of Economic Research, November 1993, p. 7.

[13] *Ibid.*, pp. 12-15.

libraries and health facilities. For several generations, its publicly supported system of higher education has been unparalleled in the world, particularly in the range of educational opportunities afforded its citizens. Historically, Californians have paid taxes at rates higher than in most parts of the United States in order to stimulate or at least stay abreast of rapid economic and population growth.

Small wonder, then, that multinational companies have sought to be active participants in the California economy. California has continually led the nation in net foreign investment. For example, virtually half of all Japanese investment in the United States during the 1980's was in California, a proportion far higher than one would expect from the size of its economy, which is approximately 12 percent of the U.S. economy.[14]

Japan is the leading source of foreign investment in California with 33.4 percent of the total in 1991.[15] The total book value of Japanese investment in California was $27.3 billion.[16] The next largest sources were the United Kingdom with $11.6 billion and the Netherlands with $11.1 billion.[17] Other countries have become increasingly important as sources of investment. For example, direct investment from Taiwan, Hong Kong, Singapore and South Korea grew collectively by 90 percent since 1988.[18]

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[14] *Ibid.*, p. 10.

[15] *Ibid.*, p. 5.

[16] *Ibid.*, p. 4.

[17] *Ibid.*

[18] *Ibid.*, p. 6.

When a company, such as Barclays, makes a decision to enter the California market, it immediately has access to the educated labor force, the technological capabilities, the transportation facilities, the markets, and the communications infrastructure which California taxpayers have helped pay for.

When a multinational corporation invests in a State, it becomes a taxpayer and a corporate citizen. As a taxpayer, it assumes the obligation to contribute to the maintenance of the public sector investments from which it benefits. It knows the tax structure and policies it will face before it takes the first step. It is also able to express its concerns in the political process about the business climate in which it has chosen to operate. California's legislators and governors are highly attuned to the concerns of those who do business in the State. The business community is influential in California's political processes.

Many of the foreign investors compete directly with California-based corporations and with each other in the California market. If some multinational corporations are given the opportunity to game the international tax system while wholly domestic corporations cannot, an essential attraction of the State — a level competitive playing field — will be destroyed and wholly domestic businesses will be put at a severe competitive disadvantage.

2. California's tax structure allows it to effectively deal with an increasingly complex international economy.

As tax collector for a highly internationalized, advanced information economy, the Franchise Tax Board has continuously improved its techniques of tax enforcement. Court decisions and administrative practice have moved the system from a relatively simple past to the complexities of

modern business enterprises.[19] If California were forced to adopt the arm's-length method used by the federal government, it would be even less able to collect taxes from multinational corporations than the federal government is because of the disparity of resources — and, the federal government's efforts are admittedly inadequate to the task.[20]

3. The California Bank and Corporation Tax, which is based upon use of WWCR, provides State revenue in excess of $5 billion dollars that is essential to the creation of the infrastructure and skilled labor pool which has made California an attractive place to invest.

The California Bank and Corporation tax is the third largest source of revenue for the State's general fund. It is expected to raise $5.1 billion, or 12.4 percent of the State's general fund revenue in 1994-95. Personal income tax is expected to account for more than $18 billion. Sales tax will add $12.7 billion.[21]

The general fund supports the State's educational system. In the 1994-95 budget, a budget which is sharply reduced from previous levels because of the State's, and in fact the world's, continuing economic problems, 9.8 percent will go

[19] Benjamin F. Miller, "Worldwide Unitary Combination: The California Practice," *The State Corporate Income Tax*, Hoover Institute Press, Stanford University, 1984, at 132.

[20] Lobel, Banta & Gueron, *Barclays: A Test of the Administration's Willingness to Collect Taxes From Multinational Corporations*, Tax Notes, June 28, 1993, at 1841; John B. Judis, *Tax Brake, Clinton's Corporate Giveaway*, The New Republic, August 23, 1993, at 15.

[21] *Governor's Budget Summary 1994-95*, Pete Wilson, Governor, State of California, Sacramento, pp. 89-95.

to higher education and 44.2 percent will support education from grades K-14.[22]

The skilled work force produced by the excellent California university system attracts foreign investors.[23] Of the total foreign investments made in the United States in the field of electronics and electric equipment manufacturing, 13.5 percent was in California. Of the foreign investment in instrument manufacturing in the United States, 10.8 percent was made in California.[24]

Despite high tax rates, foreign investors are continuing to come to California to take advantage of the skilled work force. While the growth in foreign investment in California slowed from the very rapid rates of the 1980's, in 1991 it continued at 8 percent over prior years.[25] The 8 percent growth in investment was achieved despite a severe statewide recession, economic problems in the source countries, and the existence of high tax rates.

[22] *Ibid.*, p. 80.

[23] *Foreign Direct Investment in California*, *op. cit. supra*, p. 1.

[24] *Ibid.*, p. 8.

[25] It is ironic to note that California enjoyed its greatest growth with respect to international investment in the years prior to 1988 when it moved from mandatory worldwide combined reporting to elective water's-edge reporting.

II. FOREIGN GOVERNMENTS AND CORPORATIONS SHOULD NOT BE INVITED TO USE THIS COURT TO CHANGE A SETTLED FOREIGN POLICY OF THE UNITED STATES WHICH IS THE PRODUCT OF ITS POLITICAL PROCESSES.

The Constitution gives the Executive Branch the broad power to handle the diplomatic relations with foreign governments, while it strictly confines any use of foreign policy power to override State and federal law to the treaty process. "[T]reaties made, or which shall be made, under the authority of the United States, shall be the supreme law of the land; . . ." U.S. Const., art. VI, cl. 2.

It is to be noted further that for the United States *treaty* law is not just the "supreme Law of the Land," but that it comes into being through a singularly exacting sequence. Treaties are entered into by the United States with other nations, either directly or through adherence to a common document. They are signed by a member of the executive branch. Thereafter the Senate of the United States must by resolution, two-thirds of the senators present concurring therein, give its advice and consent to ratification. This advice and consent having been given — by an extraordinary majority — the president then ratifies and confirms the treaty in an instrument of ratification. At that point, under Article VI of the Constitution the said treaty "shall be the supreme Law of the Land." Daniel Patrick Moynihan, *On the Law of Nations*, Harvard University Press, 1990, pp. 173-74.

This "singularly exacting" process gives great significance to the adoption *or* the rejection of a treaty. When the Senate gives its advice and consent to a treaty and it is ratified, the treaty becomes the supreme law of the land and the policy of

the United States. When the Senate refuses to give its advice and consent to a treaty, its provisions do not become the supreme law of the land, and the policy which the treaty represents can no longer be used to nullify state law. If this were not so, the President could establish the supreme law of the land *ex cathedra* regardless of the Senate's views. There would be no need for the Senate's advice and consent. The reasons for this balance of powers are found in the circumstances which gave rise to the adoption of the Constitution.

One of the major motivations for the adoption of the Constitution was the need to create a central government which could deal with other nations on an equal footing in the area of commercial relations. To this end, the power to make treaties was granted solely to the federal government. U.S. Const., art. I, § 10, cl. 1 and art. II, § 2, cl. 2.

The delegation of the treaty power to a federal government, while recognized as necessary, was viewed with trepidation. States, which under the Confederation were sovereigns with their own power to enter into treaties, were concerned that the delegation of this power to the central government would result in their interests being disregarded. Consequently, the structure of the government was designed to prevent this occurrence. The Senate, one of the two bodies contained in the Legislative Branch, was created as a representative of the States with each State having equal rights of representation. Furthermore, this right of equal representation could not be changed without the consent of the affected State. U.S. Const., art. V.

This Court, in recounting the history of the Commerce Clause, has recognized that protection of the sovereignty of the States is provided by the very structure of our federal government. This Court's Commerce Clause discussion is

even more apt with respect to the exercise of the treaty power. In *Garcia v. San Antonio Metropolitan Transit Authority*, 469 U.S. 528 (1985), this Court stated:

> . . . Apart from the limitation on federal authority inherent in the delegated nature of Congress' Article I powers, the principal means chosen by the Framers to ensure the role of the States in the federal system lies in the structure of the Federal Government itself. It is no novelty to observe that the composition of the Federal Government was designed in large part to protect the States from overreaching by Congress. [footnote omitted] . . . They were given more direct influence in the Senate, where each State received equal representation and each Senator was to be selected by the legislature of his State. [citation omitted] The significance attached to the States' equal representation in the Senate is underscored by the prohibition of any constitutional amendment divesting a State of equal representation without the State's consent. [citation omitted]
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> The extent to which the structure of the Federal Government itself was relied on to insulate the interests of the States is evident in the views of the Framers. James Madison explained that the Federal Government "will partake sufficiently of the spirit [of the States], to be disinclined to invade the rights of the individual States, or the prerogatives of their governments. (citation omitted)" . . . "it was a favorite object in the Convention" to provide for the security of the States against federal encroachment and that the structure of the Federal Government itself served that end. [citation omitted] . . . equal representation of the States in the Senate, which he saw as "at once a constitutional recognition of the portion of sovereignty remaining in the individual States, and an instrument for preserving that residuary sovereignty." [citation omitted] . . . "the residuary sovereignty of the States [is] implied *and secured* by that principle of representation in one branch of the [federal] legislature" [citations omitted] . . . the Framers chose to rely on a federal system in which special restraints on federal power over the States inhered principally in the workings of the National Government itself, rather than in discrete limitations on the objects of federal authority. State sovereign interests, then, are more properly protected by procedural safeguards inherent in the structure of the federal system than by judicially created limitations on federal power.
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> We realize that changes in the structure of the Federal Government have taken place since 1789, not the least of which has been the substitution of popular election of Senators by the adoption of the Seventeenth Amendment in 1913, and that these changes may work to alter the influence of the States in the federal political process. [footnote omitted] Nonetheless, against this background, we are convinced that the fundamental limitation that the constitutional scheme imposes . . . is one of process rather than one of result.
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> . . . [T]he principal and basic limit on the federal commerce power is that inherent in all congressional action — the built-in restraints that our system provides through state participation in federal governmental action. The political process ensures that laws that unduly burden the States will not be promulgated. In the factual setting of these cases the internal safeguards of the political process have performed as intended. *Garcia*, 469 U.S. 550-556.

Concerns for the sovereignty of the States were expressed through the Constitutional requirement that the Senate, by two-thirds of its members present, give its advice and consent to a treaty, U.S. Const., art. II, § 2, cl. 2. In this regard, our Constitution differs markedly from the structure of government in the United Kingdom, and most other national governments in the world, where the conduct of foreign affairs is left almost exclusively in the hands of the Executive Branch. It should not be forgotten that in designing the structure of our constitutional system, the Framers had, as a model they wished to avoid, the government of the United Kingdom.

In the debate which occurred on the Senate floor during the consideration of the US/UK treaty, Senator Frank Church recalled the concerns of our founding fathers as follows:

> There are two important principles at stake in this treaty. The first concerns the role of tax treaties in our constitutional system. Whatever tax treaties are good for, they should not be used to usurp for the executive branch of Government the power to impose major changes in internal tax policy. Yet, the United Kingdom Treaty does precisely this.
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> For some ten years, Congress has been rejecting the type of limitation on the power of our State governments to tax which is incorporated in article 9(4) of the pending treaty.
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> The second important principle concerns the proper way for resolving disputes with our federal system. . . . the States were never consulted before their tax powers were bargained away. . . .
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> . . . Congress is the forum in which disputes with the federal system [are] meant to be resolved. . . .

> . . . The original purpose for the Senate's role in the treaty process was to protect the interests of the several States in treaty matters. The framers feared that to give the executive branch of the Federal Government free rein in the treaty process would enable the President to ride roughshod over the States. We may have waited a while to see that fear confirmed, but that is exactly what article 9(4) of this treaty does. It demonstrates that the fears of the framers of our Constitution were well founded. 124 Cong. Rec. S. 18416-18417, June 22, 1978.

The failure of the United Kingdom to appreciate this fundamental difference in the form and structure of our government may explain its concerns with respect to what happened to the bilateral tax treaty which we negotiated with it, but it does not give the United Kingdom the power to dictate how our system ought to function or how this Court should construe our institutional framework. One of the primary concerns of the Framers was to preserve the individual sovereign rights of the States. The fact that the United Kingdom does not share these concerns is of little moment in this Court's interpretation of the Constitution and the significance of acts taken pursuant to its requirements.

III. THE CALIFORNIA BUDGET AND TAX CODE ARE THE HEART OF THE STATE'S POLITICAL PROCESS AND SHOULD NOT BE SET ASIDE ABSENT SPECIFIC FEDERAL LEGISLATION OR TREATIES.

Even when the federal government has legislated, it does not follow that State legislation on the same subject is automatically preempted. The test requires the presence of persuasive reasons ". . . either that the nature of the regulated subject matter permits no other conclusion or that Congress has unmistakably so ordained." *Florida Lime and Avocado*

Growers v. Paul, 373 U.S. 132, 142 (1963). Indeed, this Court sustained a State tax that differed from the federal tax, even when Congress thought State law would follow federal law, because Congress did not *require* States to follow federal law. *Amerada Hess Corp. v. New Jersey*, 490 U.S. 66, 70 (1989). In this case, Congress has refused to legislate and the Senate refused to ratify the treaty which would have preempted the State law at issue in these cases.

In this case, multinational corporations and foreign governments are asking this Court to use the Commerce Clause of the Constitution, art. I, § 8, cl. 3, and the so-called "Dormant Commerce Clause analysis" to nullify a State law for foreign policy reasons. They cite the anger of foreign governments, including, in the case of several foreign government *amici*, their own protests. They argue that there is a constitutional requirement that the United States "speak with one voice" on foreign commercial issues and that, absent federal legislation or treaties, this Court is that voice.

In the process, Petitioners are asking this Court to take the drastic step of nullifying California's political decisions that could cost California's taxpayers over $4 billion in tax revenue losses. The refunds, and the additional loss of revenue to the State treasury, will force the State to weaken its infrastructure, will put its wholly domestic companies at a competitive disadvantage, and will force a reallocation of benefits and burdens which have already been distributed, after bitter budget debate, by the California Legislature. It will come at a time when California is reeling from the impact of wildfires and now earthquakes. Each of these events by itself sends tremors through a state's budget. Cumulatively, these events will have the fiscal impact of an earthquake of at least 9.0 on the Richter scale.

What impact does $4 billion have on California's budget? In terms of services, it means, for example, the loss of ability to pay for over 100,000 teachers, send 1 million college students to State universities, or provide health coverage for over 5 million uninsured Californians. Based on current proportions in the budget, elementary and secondary education would lose $1.6 billion, higher education would lose $480 million, and health and welfare programs would lose about $1 billion. In a State which has struggled to provide basic services and resolve on-going budget deficits, it would be a staggering blow to its ability to maintain the level of public services which have contributed so much to the environment which foreign multinationals have sought.

Alternatively, the impact on California's other taxpayers would be devastating. To replace the $4 billion would mean an increase in personal income taxes of 25 percent on all taxpayers for one year. It would mean an increase in State sales taxes of 30 percent, or 2 1/2 cents. It would mean an increase of approximately 80 percent in the Bank and Corporation tax for wholly domestic companies while allowing multinational corporations to essentially escape the tax. Indeed, if Barclays and Colgate prevail, our wholly domestic companies will have to compete against multinational corporations which pay no income taxes whatsoever on their exports to the U.S. because in many countries there is no corporate income tax, only a Value Added Tax on products which is rebated to a corporation once it exports the product.

Thus, the potential costs to the State of California will be significant for every citizen and taxpayer. Either California must shift the tax burden from multinational corporations to wholly domestic corporate and individual taxpayers, or make significant cuts in vital public services thereby weakening one

of the very features which benefitted these multinational investors in the first place.

Who would be hurt by such a decision? The damage caused will be most obviously to all taxpayers and to public services, but, in addition, will disadvantage wholly domestic, small and local businesses. The prohibition of an effective method of tax enforcement — WWCR — gives multinational corporations a tax shelter that is not available to wholly domestic companies, whose income is apportioned by formula.

Barclays and Colgate demand all of this despite their failure to prove that the WWCR method is discriminatory, despite their failure to prove that the WWCR method will, in fact, result in double taxation, and despite their failure to prove that the method is burdensome. Barclays' and Colgate's real complaint is that they do not want to pay taxes. They want to continue to be able to shelter income in tax havens such as the British Crown Colony of the Cayman Islands which is now the fifth largest banking center in the world.

This court should respect us as citizens and taxpayers and protect our budget process from foreign assault. It should not allow itself to be used by multinationals as a tool to undermine our Nation's fundamental democratic institutions.

Further, we believe that the language in the *Container* case, 463 U.S. 159, at 194 (1983), which suggests that if there is a credible threat of foreign government retaliation, it may be appropriate for this Court to use foreign policy as a reason to nullify State law, under the Commerce Clause, should be disclaimed. The language opens the door to foreigners who will make threats just to reenforce their "Dormant Commerce Clause" arguments. The threats will give foreign governments a stronger hand in shaping state fiscal policy than we give our own citizens.

CONCLUSION

For the foregoing reasons, *amici curiae* urge this Court to affirm the decisions of the California courts.

Dated: January 19, 1994

Respectfully submitted,

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Nos. 92-1384 and 92-1839

In The

Supreme Court of the United States

October Term, 1993

No. 92-1384

BARCLAYS BANK PLC,

Petitioner,

v.

FRANCHISE TAX BOARD,
AN AGENCY OF THE STATE OF CALIFORNIA,

Respondent.

No. 92-1839

COLGATE-PALMOLIVE COMPANY,

Petitioner,

v.

FRANCHISE TAX BOARD,
AN AGENCY OF THE STATE OF CALIFORNIA,

Respondent.

On Writ Of Certiorari To The Court Of Appeals Of The State Of California, In And For The Third Appellate District

AMICUS CURIAE BRIEF OF CITIZENS FOR TAX JUSTICE IN SUPPORT OF RESPONDENT FRANCHISE TAX BOARD

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January 19, 1994

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QUESTIONS PRESENTED

1. Whether California's application of worldwide combined reporting to determine the taxable income of domestic corporations with foreign parents, or foreign corporations with either foreign parents or foreign subsidiaries, is unconstitutional under the foreign Commerce Clause.

2. Whether California's application of worldwide combined reporting to determine the taxable income of domestic corporations with foreign parents, or foreign corporations with either foreign parents or foreign subsidiaries, intrudes into an inherently federal area and is pre-empted by the United States Constitution.

3. Whether California's application of worldwide combined reporting to determine the taxable income of domestic corporations with foreign parents, or foreign corporations with either foreign parents or foreign subsidiaries, is unconstitutional under the Commerce Clause where such application imposes discriminatory compliance burdens on such entities.

4. Whether California's system for compliance with worldwide combined reporting violates the Due Process Clause of the United States Constitution where compliance is not possible without undue cost and the system, to function, depends on discretionary relief provisions without constitutionally sufficient standards to guide application and prevent arbitrary enforcement.

QUESTIONS PRESENTED – Continued

In its *Amicus Curiae* Brief, Citizens for Tax Justice shall address only the first two questions set forth above.[1]

[1] *Amicus* Citizens for Tax Justice has received consent from all parties to file this brief and will file written confirmation of those consents with the Clerk of the Court.

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On Writ Of Certiorari To The Court Of Appeals Of The State Of California, In And For The Third Appellate District

AMICUS CURIAE BRIEF OF CITIZENS FOR TAX JUSTICE IN SUPPORT OF RESPONDENT FRANCHISE TAX BOARD

STATEMENT OF INTEREST OF AMICUS CURIAE CITIZENS FOR TAX JUSTICE

Citizens for Tax Justice (CTJ) is a coalition of national public interest organizations, labor unions, and citizens groups around the country. CTJ was founded in 1979 and is headquartered in Washington, D.C.. Through its member organizations, CTJ represents the interest of tens of millions of middle and lower-income taxpayers. Several of CTJ's members also represent state and local government workers around the country, including California.

As a representative of middle and lower-income taxpayers and of state and local government workers, CTJ has a vital interest in the outcome of the cases before the Court. The decision of the Court in these cases will affect the right of California and other states to assess a fair share of the tax burden on multinational corporations that do business in those states. The pending cases will therefore directly affect both state and local taxpayers and state and local government workers, since a decision against the State of California in these cases is likely to mean increased personal taxes, reduced government services or both in the states which are affected.

SUMMARY OF ARGUMENT

This case involves an issue that the states fought – and won – in the negotiations over the U.S.-U.K. tax treaty. Essentially, Petitioner Barclays Bank PLC (hereinafter "Barclays") is asking this Court to renegotiate the U.S.-U.K. tax treaty by holding that it is unconstitutional for California to apply worldwide combined reporting

(WWCR) to members of a unitary business controlled by Barclays, a British corporation. Yet both the United States and the United Kingdom consented to the application of WWCR in exactly this situation when they entered into the U.S.-U.K. tax treaty.

To be sure, an earlier, unratified version of the treaty, negotiated by the Executive branch, contained an unprecedented provision that would have prevented the application of worldwide combined reporting (WWCR). Exercising its Constitutional powers, the Senate refused to ratify this version of the treaty.

The Executive branch could obtain Senate approval only after this restriction on WWCR was removed from the treaty. In order to compensate the United Kingdom for the continued right of the states to use WWCR and in order to induce it to enter into a treaty that permitted WWCR, the Executive branch made concessions to the U.K. in other provisions of the treaty. The Senate then ratified the treaty with these concessions and without any restrictions on WWCR. These events, as well as statements by both governments, make it perfectly clear that the United Kingdom and the United States recognized that states could apply WWCR to a taxpayer such as Barclays. Indeed, Barclays is not claiming that California's use of WWCR violates the treaty.

This Court is now being asked to do what the United Kingdom and the Executive branch of the United States government could not do through the treaty process and outlaw WWCR. But the Senate is the proper body to renegotiate the treaty. Only through renegotiation of the treaty could the Senate reclaim the concessions that were

previously made to the United Kingdom as a quid pro quo for WWCR.

The Executive branch and the United Kingdom made the best bargain they could at the time in light of the Senate's sentiments. Certain past and current officials in the Executive branch have been unhappy with the treaty's resolution of the WWCR issue and have attempted through the political process to curtail this method of taxation. They have been notably unsuccessful in convincing the Legislative branch of the government to exercise its Constitutional powers to regulate interstate and foreign commerce by passing legislation governing WWCR. They have been more successful in using political suasion in encouraging states to curtail voluntarily their taxing powers. In response to these pressures, California has abandoned the mandatory use of WWCR. The Court should find that, under the facts presented in these cases, the federal government has not abandoned, by law, policy or action, its approval of California, or any other state's right, to impose WWCR should it determine to do so.

ARGUMENT

NEGOTIATIONS OVER THE U.S.-U.K. TAX TREATY MAKE IT CLEAR THAT BOTH THE UNITED STATES AND THE UNITED KINGDOM AUTHORIZED THE APPLICATION OF WORLDWIDE COMBINED REPORTING TO CORPORATIONS SUCH AS BARCLAYS

The events surrounding the ratification of the U.S.-U.K. tax treaty make it clear that both the United States

and the United Kingdom authorized the application of WWCR to corporations such as Barclays. The California tax on Barclays is consistent with the treaty and reflects the understanding of both countries. Because WWCR is consistent with the treaty, which is the supreme law of the land, it cannot be invalidated under a dormant foreign commerce clause analysis.

In 1975, the Executive branch negotiated a revision of the existing tax treaty with the United Kingdom. Article 9(4) of this proposed revision would have barred California (and other states with similar tax regimes) from imposing WWCR on British corporations such as Barclays.[2] The proposed Article 9(4) was recognized by all parties to be an attack on WWCR. For example, the Treasury Department's June 8, 1976 submission of this version of the treaty to the President stated:

> "This provision represents the first attempt to bind State and local taxing authorities by a substantive provision of the treaty (other than nondiscrimination). Under the basic rules of our other tax conventions a contracting State entering into such tax conventions is prohibited from taking into account, in determining the tax liability of an enterprise doing business in that contracting State, the income, expenses, etc. of related enterprises of the other contracting State, or in other countries of those enterprises if those enterprises are not engaged in business in the contracting State, except to the extent that

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[2] Article 9(4) in the final treaty does not bar either the United States or the United Kingdom from extensively using formulary apportionment within the context of an arm's length standard. This aspect of Article 9(4) was uncontroversial.

> inter-company transactions are not conducted on an arm's length basis. This treaty, for the first time, extends this limitation to State and local tax authorities with respect to enterprises controlled by United Kingdom residents. This limitation is directed at the practice of a few states which are attempting to take into account the income on a consolidated basis of all related foreign enterprises in assessing the State income tax of a single member of the related group doing business in the State."[3]

This unprecedented attempt to limit state taxation touched off a heated and extensive debate. Ultimately, the treaty could not be ratified without a reservation to this part of Article 9(4).

The Senate's reservation was a blow to the United Kingdom, whose business community felt strongly about obtaining a prohibition on WWCR. The reservation also foiled the United Kingdom's attempt to use the treaty to circumvent Congress' consistent refusal to enact legislation outlawing WWCR. Such legislation had been debated for ten years prior to the introduction of the U.K. treaty; even in the midst of debate over the treaty there were suggestions to substitute a legislative response for Article 9(4), but the Congress adamantly refused to interfere with the taxing power of the states.[4]

[3] Reprinted in P-H Tax Treaties, United Kingdom – Income Tax Treaty, at 89,050 (1976).

[4] For some of the bills that would have, inter alia, affected the states' use of WWCR, see H.R. 11798 (1965); S. 916 (1969); S. 317 (1971); S. 4080 (1972); S. 2173 (1977); S. 1688 (1979); H.R. 5076 (1979); H.R. 5903 (1979); H.R. 8277 (1980); H.R. 1983 (1981);

The Senate's ratification of the treaty with a reservation to Article 9(4) raised doubts about whether the British would sign the revised treaty. In addition to the strong business opposition in the United Kingdom to the reservation, there was concern over the growing cost of a retroactive refund to U.S. investors of the British Advance Corporation Tax, which the proposed treaty provided.[5] Not surprisingly, the British requested additional concessions for the Senate's refusal to prohibit WWCR[6] and the Executive branch entered into further negotiations with the United Kingdom. To induce the British to enter into the treaty with the Senate reservation and to compensate them for the states' use of WWCR, the Executive branch made concessions to the British in other provisions of the treaty.[7] These changes were reflected in

H.R. 6402 (1982); H.R. 2918 (1983); H.R. 3243 (1983); S. 1225 (1983); H.R. 4940 (1984); H.R. 6146 (1984); S. 3061 (1984); H.R. 3980 (1985); S. 1113 (1985); S. 1974 (1985).

[5] Third Protocol to the 1975 Income Tax Convention with the United Kingdom of Great Britain and Northern Ireland, as Amended, Report of the Committee on Foreign Relations, United States Senate on Executive Q, 96th Cong., 1st Sess., p. 47 (June 15, 1979). It was estimated that the retroactive refund would cost over $500 million through 1979. *Id.*

[6] According to Donald C. Lubick, Assistant Secretary for Tax Policy, "it was reasonable to expect the British to request some additional concession for the loss of the benefits of Article 9(4) . . . " *Id.* at 46.

[7] Donald C. Lubick, Assistant Secretary for Tax Policy, stated that "The British authorities view some of the provisions of the Third Protocol (particularly the North Sea permanent establishment rules) as a concession for the deletion of Article 9(4)." *Id.* at 46. The British Treasury Chief Secretary stated upon adoption of the Treaty: "the United Kingdom, recognizing the

the Third Protocol to the Treaty. As the Senate prepared to vote on the Third Protocol, it understood that it faced the following policy choice: if the treaty were to be approved, there could be no prohibition on WWCR; with such a prohibition, the treaty would not be ratified.[8] The Senate ratified the revised treaty with no prohibition on the states' use of WWCR by voting unanimously in favor of the Third Protocol. The Report of the Senate Foreign Relations Committee leaves no doubt that both the United States and the United Kingdom interpreted the treaty as authorizing the use of WWCR:[9]

> "Under the protocol, political subdivisions and local authorities of either country are free to use formula methods to apportion income, deductions, and other items among related enterprises in determining income subject to their taxes, so long as such methods do not violate the proposed treaty's nondiscrimination provisions (Article 24)."

California's use of WWCR is clearly within the bounds of this authorization because it does not violate the treaty's nondiscrimination clause, nor does either Petitioner allege such a violation.

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difficult constitutional problem in the United States which the application of Article 9(4) to individual State taxes posed and the *compensatory offer* which the United States has made, has acquiesced in the Senate reservation but has done so only with the greatest reluctance." Quoted in Kane, James M., "International Tax Treaties and State Taxation: Can the Federal Government Speak with One Voice?", 10 VIRGINIA TAX REVIEW 765, 781 (1991) (emphasis added).

[8] See 125 Cong. Rec. 17427-34 (July 8, 1979).

[9] *Supra* note 5 at 5.

Notwithstanding the unambiguous statements made by officials in both the United States and the United Kingdom that they understood the treaty as authorizing WWCR, and despite the United States "paying" for WWCR by making further concessions to the British, Petitioners would prefer an explicit statement authorizing WWCR in the body of the treaty. This requirement would impose a near impossible standard because neither the Senate nor the entire Congress is in the business of expressly reaffirming state taxing powers and there was no reason to start doing so in the U.S.-U.K. treaty.

First, the British obviously had no reason to demand such a statement. Neither, however, did the states. The whole debate over Article 9(4) proceeded on the assumption that the states had the right to impose WWCR unless otherwise restricted by the treaty (or federal legislation). Second, no tax treaty before or after the U.K. treaty has ever reaffirmed a state taxing power. Considerations of fiscal federalism have removed such powers from the purview of tax treaties. It would have been unprecedented for a tax treaty to have provided authorization for WWCR (or, for that matter, to provide for any other similar feature of state taxation). Third, an explicit provision in the U.K. treaty authorizing WWCR would have raised a negative inference about the constitutionality of other aspects of a state's tax regime, such as the taxation of foreign source dividends.

Nor do the recent cases of this Court demand that the treaty contain an express affirmation of WWCR. For example, the present case presents a more compelling situation than did *Wardair Canada, Inc. v. Florida Dept. of Revenue*, 477 U.S. 1 (1986) for finding that "the Federal

Government has affirmatively acted, rather than remained silent, with respect to the power of the States to tax . . . and thus that the case does not call for dormant foreign commerce Clause analysis at all." *Id.* at 9. *Wardair* upheld Florida's excise tax on fuel purchased by a Canadian airline for use exclusively in foreign commerce. In *Wardair*, the taxpayer argued that there was a federal policy to exempt the purchase of such fuel and that the Florida tax interfered with the government's ability to speak with one voice.

In support of its position, Wardair cited the Chicago Convention on International Civil Aviation, which precluded the imposition of local taxes on fuel only when the fuel was already on board an aircraft on arrival and retained on board on leaving; the Convention did not address the taxation of fuel purchased locally after arrival. *Id.* at 10. The Court held:

> "that the negative implications of this provision support recognizing Florida's power to tax; certainly, the provision demonstrates the international community's awareness of the problem of state and local taxation of international air travel, specifically aviation fuel, and represents a decision by the parties to that Convention to address the problem by curtailing and limiting only some of the localities' power to tax, while implicitly preserving other aspects of that authority." *Id.* at 10.

The facts in *Barclays* present an even stronger case in favor of upholding the California tax than did the facts in *Wardair* for upholding the Florida tax. The exhaustive debate over Article 9(4) in the U.S.-U.K. treaty, the earlier

legislative attempts to deal with WWCR, and the reservation by the Executive branch to the 1963 and 1977 OECD Model Treaty clause[10] that would have had the effect of prohibiting state use of WWCR, demonstrate the international community's long-standing awareness of the problem. The Senate's reservation, combined with the concessions made to the United Kingdom, represent a decision by the parties to address the problem by preserving the states' power to tax. Even before *Wardair*, the Court recognized that where there has been ample debate over a tax issue, Congress' preservation of the status quo by refusing repeatedly to adopt legislation is support for concluding that Congress has acquiesced in the *status quo*.[11]

There are other strong parallels with *Wardair*. In *Wardair*, the Court said:

> "[m]ost strikingly as it relates to the case before us, the U.S.-Canadian Agreement itself limits the tax exemption to be afforded to foreign air carriers to 'national duties and charges.' Taxation by political subdivisions of either the United States or Canada are not mentioned, an

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[10] 1963 and 1977 OECD Model Income Tax Treaties and Commentaries: A Comparative Presentation (1987), at 16-17.

[11] See *Bob Jones University v. United States*, 461 U.S. 574, 600 (1983). The only difference between *Wardair* and *Barclays* is that in the former there was a provision precluding some local taxation of fuel whereas in the latter the prohibition is more general in that a state tax cannot be discriminatory. But this difference is irrelevant because the entire debate over WWCR leaves no doubt that the treaty was intended to permit the continued state use of WWCR.

> omission which must be understood as representing a policy choice by the contracting parties . . . ". *Wardair*, at 11.

Article 9(4) of the U.S.-U.K. treaty, similar to the U.S.-Canadian agreement, speaks only to national taxes. Taxation by political subdivisions of the United States is not mentioned in the U.S.-U.K. tax treaty, an omission that, in the context of the robust debate over Article 9(4), represents a clear, bargained for, policy choice by the contracting parties.

In *Wardair* the Court concluded that

> "[w]hat all of this makes abundantly clear is that the Federal Government has not remained silent with regard to the question whether States should have the power to impose taxes on aviation fuel used by foreign carriers in international travel. By negative implication arising out of more than seventy agreements entered into since the Chicago Convention, the United States has at least acquiesced in state taxation of fuel used by foreign carriers in international travel. Again, in the U.S.-Canadian agreement only 'national' charges are barred, and we presume that drafters from two federalist nations understood this as representing a choice not to preclude local taxation." *Id.* at 12.

Obviously, the debate over Article 9(4) and the Senate reservation represents a similar choice not to preclude the use of WWCR by the states. And, as was true in *Wardair*, in all the treaties negotiated since the U.S.-U.K.

treaty – more than 20 of which have already been signed[12] – the United States has never tried to impose any restrictions on the states' use of WWCR. The U.S.-U.K. tax treaty in particular, and the entire 25 year debate over WWCR starting in the early to mid 1960s,[13] would hardly qualify as Congressional silence. To the contrary, there has been a strident and contentious debate over whether to curtail WWCR.

The legislative history of the U.S.-U.K. treaty demonstrates what the expectations of the parties were. Accordingly, there is no need for the Court to address whether, in the absence of the U.S.-U.K. treaty, the foreign commerce clause would invalidate California's tax. "It would turn dormant Commerce Clause analysis entirely upside down to apply it where the Federal Government has acted, and to apply it in such a way as to reverse the policy that the Federal Government has elected to follow." *Wardair*, at 12. "[T]he Federal Government is entitled in its wisdom to act to permit the States varying degrees of regulatory authority." *Id.*

To be sure, some former officials in the Executive branch have challenged the wisdom of the Legislative branch in permitting worldwide combined reporting. They pressed their concerns through press releases, speeches, *amicus* briefs, letters, political suasion, and attempts to pass legislation. They did not, however,

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[12] See Tax Analysts, Worldwide Tax Treaty Index, May 1993, at 85-92; 8 Tax Notes Int'l, 36 (January 3, 1994).

[13] The debate can be marked as either starting with H.R. Rep. No. 1480, 88th Cong. 2nd Sess. (Willis Committee report) in 1964 or with the introduction of H.R. 11798 in 1965.

attempt again to use the treaty mechanism to prohibit WWCR because they recognized that the Senate would not ratify any treaty containing such a provision.[14]

Consistent with *Wardair*, these Executive branch complaints deserve no legal weight. They carry even less weight than a Resolution adopted by the International Civil Aviation Organization, which the taxpayer cited in *Wardair* in support of its position that the Florida tax should be struck down under the dormant foreign commerce clause. The Court characterized the resolution as "an international aspiration on the one hand to eliminate all impediments to foreign air travel . . . ". *Wardair* at 10. The Court described the Resolution as "formally merely the work product of an international organization of which the United States is a member; it has not been specifically endorsed, let alone signed, entered into, agreed upon, approved, or passed by either the Executive or Legislative Branch of the Federal Government. In other words, no action has been taken to give the Resolution the force of law."[15] *A fortiori*, complaints by former officials in the Executive branch that do not even rise to the level of an International Resolution should not carry any more authority than the Resolution did in *Wardair*. Complaints about WWCR may represent "aspirations" but

[14] Statement of Donald C. Lubick regarding the United States Model Tax Treaty, Hearings before the Committee on Foreign Relations, United States Senate, 96th Cong., 1st Sess. (June 6, 1979), p. 112.

[15] *Id.* at 11. The closest parallel to the Resolution is the OECD Model Tax Treaty. The United States, however, has taken a reservation to that part of the Model that would have applied to subnational taxes. See *supra* note 10.

until acted upon by the Legislative branch through a treaty or legislation remain just that – aspirations.

Itel Containers International Corp. v. Huddleston, 113 S. Ct. 1095 (1993), lends yet additional support to California's position. In *Itel*, the federal government had adopted various conventions, statutes, and regulations, restricting the ability of the states to tax international cargo containers in defined circumstances. State taxes collected in connection with the importation of cargo containers were also prohibited. The sales tax at issue in *Itel* did not fall within those proscriptions, "and the most rational inference to be drawn is that [the Tennessee sales tax], one quite distinct from the general class of import duties, is permitted." *Id.* at 1105. *Barclays* presents a much easier case than *Itel*; there is no proscription against WWCR for reasons that are well documented. WWCR does not fall within any of Article 9(4)'s constraints on WWCR, which apply only to the United States and the United Kingdom,[16] because of the bargain struck between the two countries. Moreover, *Barclays* is not a situation in which there is "congressional authorization for [WWCR] in congressional silence."[17] The vociferous debate over Article 9(4) is hardly tantamount to Congressional silence.

[16] See *supra* note 2.

[17] *Itel* at 1110 (Blackmun, J., dissenting).

CONCLUSION

The U.S.-U.K. treaty was understood by the signatories as permitting WWCR. The Court's recent decisions in *Wardair* and *Itel* merely underscore that conclusion. Accordingly, this Court should affirm the judgments below.

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On Writ Of Certiorari To The Court Of Appeals Of The State Of California In And For The Third Appellate District

AMICUS CURIAE BRIEF OF MULTISTATE TAX COMMISSION IN SUPPORT OF RESPONDENT FRANCHISE TAX BOARD

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QUESTIONS PRESENTED

1. Whether California's application of worldwide combined reporting to determine the taxable income of domestic corporations with foreign parents, or foreign corporations with either foreign parents or foreign subsidiaries, is unconstitutional under the foreign Commerce Clause.

2. Whether California's application of worldwide combined reporting to determine the taxable income of domestic corporations with foreign parents, or foreign corporations with either foreign parents or foreign subsidiaries, intrudes into an inherently federal area and is pre-empted by the United States Constitution.

3. Whether California's application of worldwide combined reporting to determine the taxable income of domestic corporations with foreign parents, or foreign corporations with either foreign parents or foreign subsidiaries, is unconstitutional under the Commerce Clause where such application imposes discriminatory compliance burdens on such entities.

4. Whether California's system for compliance with worldwide combined reporting violates the Due Process Clause of the United States Constitution where compliance is not possible without undue cost and the system, to function, depends on discretionary relief provisions without constitutionally sufficient standards to guide application and prevent arbitrary enforcement.

QUESTIONS PRESENTED – Continued

In its *Amicus Curiae* Brief, the Multistate Tax Commission shall address only Questions 1 and 2 of the Questions Presented.[1]

[1] The Multistate Tax Commission has received consent from all parties to file this brief and will file written confirmation of those consents with the Clerk of the Court.

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MISCELLANEOUS

Nos. 92-1384 and 92-1839

In The

Supreme Court of the United States

October Term, 1993

No. 92-1384

BARCLAYS BANK PLC,

Petitioner,

v.

FRANCHISE TAX BOARD,
AN AGENCY OF THE STATE OF CALIFORNIA,

Respondent.

No. 92-1839

COLGATE-PALMOLIVE COMPANY,

Petitioner,

v.

FRANCHISE TAX BOARD
AN AGENCY OF THE STATE OF CALIFORNIA,

Respondent.

On Writ Of Certiorari To The Court Of Appeals Of The State Of California In And For The Third Appellate District

AMICUS CURIAE BRIEF OF MULTISTATE TAX COMMISSION IN SUPPORT OF RESPONDENT FRANCHISE TAX BOARD

STATEMENT OF INTEREST OF AMICUS CURIAE MULTISTATE TAX COMMISSION

The Multistate Tax Commission ("MTC" or "Commission") is the official administrative agency of the Multistate Tax Compact ("Compact"). Currently, the Compact has been entered into by 19 states and the District of Columbia as full members; and 13 additional states have joined the Commission as associate members.[1] The stated purposes of the Compact are to:

> 1. Facilitate proper determination of State and local tax liability of multistate taxpayers, including the equitable apportionment of tax bases and settlement of apportionment disputes.
>
> 2. Promote uniformity or compatibility in significant components of tax systems.
>
> 3. Facilitate taxpayer convenience and compliance in the filing of tax returns and in other phases of tax administration.
>
> 4. Avoid duplicative taxation.

As reflected by these four basic principles, the Commission possesses vital and continuing interest in those state tax issues that may radically affect the administration of state tax systems. The pending cases have that potential. The issues contained in these two cases strike close to the core of one of the Commission's overall responsibilities – to ensure that state tax systems are allowed to innovate and develop more sophisticated methods of taxing business activities conducted within their jurisdictions, and to adapt those systems in response to evolving social and economic conditions.

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[1] The current full members are the states of Alabama, Alaska, Arkansas, California, Colorado, District of Columbia, Hawaii, Idaho, Kansas, Minnesota, Missouri, Michigan, Montana, New Mexico, North Dakota, Oregon, South Dakota, Texas, Utah, and Washington. The associate members are the states of Arizona, Connecticut, Georgia, Louisiana, Maine, Maryland, Massachusetts, New Hampshire, New Jersey, Ohio, Pennsylvania, Tennessee and West Virginia. To the extent that any member state of the Commission files a separate brief in this case, this *amicus curiae* brief does not represent the position of said state or states in this case.

SUMMARY OF ARGUMENT

Petitioners seek to elevate the "squeaking" of foreign multinationals, the "bullying shouts" of a few foreign governments, and the occasional "whining" of a few ex-officials of the Executive branch to the federal government's "one voice". The Court is being asked to follow these voices, as if they were the calls of the Pied Piper. However, when all of the self-serving noise and clutter are filtered out, one clear message emerges: worldwide combined reporting (hereafter "WWCR") is consistent with and not in opposition to policies adopted by the federal government with respect to the state taxation of foreign commerce.

No need for a dormant foreign commerce clause analysis exists in the cases before the Court because the circumstances surrounding the Senate ratification of the U.S.-U.K. Tax Treaty demonstrate that both countries acquiesced to the states' uses of WWCR. In particular, the Senate's reservation to proposed Article 9(4) of the Treaty clearly establishes that California's WWCR does not violate the "one voice" prong of *Japan Line, Ltd. v. County of Los Angeles*, 441 U.S. 434 (1979). Since this aspect of the "one voice" issue has been extensively addressed in the Brief of Respondent, the Commission will not repeat it here, but will deal primarily with the dormant federal commerce clause issue that is reached if the Court hears voices other than those expressed by Respondent and its *amici*.

Worldwide combined reporting for state tax purposes greatly reduces the opportunity for tax planning and tax avoidance with regard to international business activities conducted by domestic or foreign-based taxpayers. WWCR addresses more effectively than any arm's length or separate accounting method the taxation of income derived by a unitary business from international transactions, regardless of their operating in or through the various tax havens. This method of accounting (which its detractors often intentionally mislabel a "tax") is a product of our federal system. It was conceived, developed and advanced by the states to maturity over the past 40 years or so. The teaching of *Garcia v. San Antonio Metropolitan Transit Authority*, 469 U.S. 528 (1985) suggests that it be left to

Congress to advance or limit the states' sovereignty in this area.

Even applying the test in *Japan Line*, WWCR should be upheld. More fundamentally, the *Japan Line* analysis is not appropriate in a global economy. To the extent that *Japan Line*'s rationale has survived subsequent decisions of the Court, it is clearly not properly applied outside the context of a tax, such as a property tax, for which no existing pattern or practice of eliminating double taxation exists. The Court's decisions in *Wardair Canada, Inc. v. Florida Dep't. of Revenue*, 477 U.S. 1 (1986) and *Itel Containers International Corp. v. Huddleston*, ___ U.S. ___, 113 S.Ct. 1095 (1993) have all but overruled key holdings of *Japan Line*.

At issue in both cases is the use of the same type of accounting method, worldwide combined reporting. While all of the arguments that are set forth by the Commission are specifically addressed to Petitioner Barclays, with no specific mention of Petitioner Colgate-Palmolive Co., a very critical relationship exists between the issues in the two pending cases. If this Court were to prohibit WWCR in the case of *Barclays*, then, as a political matter, state legislatures will find it nearly impossible to apply WWCR to U.S.-based multinationals. A decision in favor of Petitioner Barclays under the foreign commerce clause (U.S. CONST. ART. I, § 8, cl. 3) will be tantamount to overruling the result in *Container Corp. of America v. Franchise Tax Board*, 463 U.S. 159 (1983).

ARGUMENT

I. THE DORMANT FOREIGN COMMERCE CLAUSE DOES NOT PROHIBIT WORLDWIDE COMBINED REPORTING

A. The Dormant Foreign Commerce Clause Analysis Fashioned in *Japan Line* is Reminiscent of the Discredited *Cooley* Doctrine and is Unworkable.

The Court's dormant foreign clause analysis as formulated in *Japan Line* is reminiscent of the so-called *Cooley* doctrine, set forth in *Cooley v. Board of Wardens*, 53 U.S. (12 How.) 299 (1851). This similarity is not surprising because in both cases

the Court was struggling with the same issue: when does a state's action unconstitutionally impact on multijurisdictional economic activity. In *Cooley*, the Court held that the states could not regulate those aspects of interstate commerce that were so national in character that a single, uniform rule was necessary. *Id.* at 319. To paraphrase *Cooley* using the language of *Japan Line*, state regulations would be unconstitutional if they would "impair federal uniformity in an area where federal uniformity is essential." *Japan Line*, 441 U.S. at 448.

Over time, the *Cooley* doctrine proved unworkable for reasons that do not augur well for the Court's current formulation of dormant foreign commerce clause analysis. In the comparatively undeveloped U.S. economy of 1851, with a primitive transportation and communication infrastructure, there was less interdependency between the local and national economy. In this relatively uncomplicated era, the *Cooley* doctrine must have seemed manageable. As the country developed, however, the frequency of cross-border activities increased exponentially, and the line between local and interstate commerce became less distinct. Almost any state regulation had some impact on interstate commerce. The courts found it difficult, if not impossible, to determine which areas were, by their nature, inherently national.

According to a leading constitutional casebook, "the Court is not particularly well-suited for determining whether a given problem 'requires' a national solution as opposed to treatment tailored to local conditions,"[2] a sentiment that the Court itself has expressed in the context of the dormant foreign commerce clause. See *Container Corp. of America*, 463 U.S. 159, 194, 196. Because of the difficulty of identifying inherently national areas of interstate commerce, a subsequent doctrine, related to the *Cooley* doctrine developed. This doctrine required the Courts to distinguish between the constitutional "indirect" regulation of commerce and unconstitutional "direct" regulation.

[2] DAVID CRUMP, ET AL., CASES AND MATERIALS ON CONSTITUTIONAL LAW 195 (1989).

That distinction was also criticized as being too mechanical and conclusory.[3]

Eventually, the earlier doctrines were discarded and "the tangled underbrush of past cases" was cleared. *Miller Bros. v. State of Maryland*, 347 U.S. 340, 344 (1954). The modern domestic dormant commerce clause analysis is now embodied in the four tests set forth in *Complete Auto Transit v. Brady*, 430 U.S. 274 (1974). In the domestic situation, a tax will be upheld if it: is applied to an activity with a substantial nexus with the taxing state; is fairly apportioned; does not discriminate against interstate commerce; and is fairly related to the services provided by the taxing state. *Id.* at 279. For purposes of the interstate commerce clause, *Complete Auto* abandoned any attempt to determine the need for federal uniformity or the need for the government to speak with one voice.

The same economic forces that undermined the *Cooley* doctrine and its progeny domestically are still at work internationally, undermining *Japan Line*. As the world's economies become more interdependent, state regulations and taxes now increasingly impact foreign commerce as well as interstate commerce. State corporate takeover legislation, plant closing laws, right to work laws, policies on resource extraction, governmental procurement preferences, environmental, product liability, and antitrust regulations have a global impact through interlinked trade and investment ties. Environmental issues such as acid rain or global warming demonstrate that the economic and social welfare of individuals in any political jurisdiction are inextricably linked to the actions and interests of individuals living elsewhere. For example, a state such as California that has adopted pollution control and automobile emission standards more stringent than federal law has an impact on cars manufactured all around the globe.

As the world of *Cooley* evolved into the global marketplace, the role of state and local government has also evolved. "[S]ubnational governments have traditionally served as valuable innovators and incubators of policy ideas in many

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[3] Gerald Gunther, Constitutional Law 242 (1985).

different fields. The central difference now is the extension of this function to the foreign policy arena. . . . "[4] National borders have now become as porous as state borders. All of the examples noted above raise possible violations of the dormant foreign commerce clause. To sort through the panoply of state laws to decide which ones impact on the need for national uniformity is to sink into the *Cooley* quagmire.

B. The Federal Government Does Not Speak with One Voice on the Issue of WWCR Nor Does the Federal Government Consider Such Uniformity Essential

1. No Weight Should be Given to Complaints of Foreign Governments About WWCR

Japan Line takes the position that a state taxing scheme violates the dormant foreign commerce clause if it impairs federal uniformity in an area where federal uniformity is essential and if it prevents the federal government from speaking with one voice in international trade. *Container*, 463 U.S. at 193. In support of their assertion that WWCR runs afoul of the "one voice" metaphor, Petitioners cite the complaints of other countries against WWCR. These complaints are simply evidence of the success of WWCR in controlling tax avoidance by foreign-based multinationals and should be given no weight in assessing the constitutionality of WWCR.

When multinational firms began operating extensively in California during the 1960's and early 1970's, the state faced

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[4] John M. Kline, United States' Federalism and Foreign Policy, in States and Provinces in the International Economy, eds., Douglas M. Brown and Earl H. Fry (1993), 225. As a another illustration of the world's linked destinies, the European Community was particularly concerned with California's 1990 debate over Proposition 128, which would have imposed limits on the pesticide content of food that differed from federal standards. The EEC sent an "aide memoire" to the U.S. State Department, expressing concern that Proposition 128 could be "a means of arbitrary discrimination or a disguised restriction on trade, thereby unjustifiably increasing fragmentation of the U.S. market and adversely affecting international trade." *Id.* 219-20.

two policy options. It could continue to apply formulary apportionment and combined reporting to unitary businesses operating domestically but switch to the federal system of separate entity accounting and source rules for unitary businesses operating internationally. Or it could apply its formula apportionment statute (including combined reporting for unitary businesses of multiple corporations) to California members of all unitary businesses, regardless of whether those businesses operated internationally and regardless of where they were incorporated. California chose the second option. As more worldwide businesses were attracted to California, the state's application of what became known as worldwide combined reporting naturally occurred more often and created more notice.

The second option was fully consistent with California's domestic approach. The same reasons that led California and many states to use formulary apportionment and combined reporting for unitary businesses operating domestically applied equally, if not more strongly, in an international setting. Formulary apportionment and combined reporting eliminate the opportunities to avoid tax through the use of transfer prices and tax havens – opportunities that are particularly serious in an international setting.[5] One of the premises of the California approach in the domestic setting was that the tax paid by a unitary business should not be a function of the way it is organized on paper; California had no good reason to reject that premise just because part of the unitary business was conducted abroad or just because a corporation filed its incorporation papers abroad. WWCR merely extends California's domestic approach, based on substance over form, across national boundaries.

To implement its system internationally in a world marked by tax havens and great diversity in taxing rules, the federal

[5] Michael J. McIntyre, Design of a National Formulary Apportionment Tax System, in Proceedings of the Nat'l. Tax Ass'n/Tax Inst. of Am. 84th An. Conf. at 118 (November 1991).

government has had to develop source rules,[6] police transfer prices, and adopt anti-tax haven measures. The difficulties the IRS had, and continues to have, in policing transfer prices were well-known and it was doubtful that a state could independently administer an arm's length standard.[7] Subsequent events have borne out these fears.

Faced with these two choices, it is entirely understandable why California opted for WWCR. WWCR eliminates the need to police transfer prices, generally does away with source of income rules, and undercuts the use of tax havens. Tax planning that minimizes the federal income tax is typically useless under WWCR. Consequently, after WWCR was adopted, corporations able to pay no federal income tax now found themselves paying California tax, a situation that a foreign corporation or country not familiar with the federalist structure of the United States might not fully understand or appreciate.[8]

Certainly banks such as Barclays, with offices in some of the best-known tax havens of the world – Bahamas, Barbados, Bermuda, Cayman Islands, Channel Islands, Gibraltar, Hong

[6] Source rules serve two distinct purposes. First, they serve a jurisdictional purpose in that foreigners are generally taxed on only U.S. source income. Second, they determine how much of a credit a U.S. taxpayer will receive for foreign income taxes imposed on foreign source income. For an exhaustive treatment, see Michael J. McIntyre, The International Income Tax Rules of the United States, ch. 4(1989).

All the attention focused on transfer pricing problems has overshadowed a major weakness in the federal system: the need to develop a set of workable source rules that can be easily administered, that can not be manipulated by the taxpayer, that reflect some acceptable notion about economic nexus, and that assign income to countries inclined to tax it. See *id.* at 3-66 - 3-70. Formulary apportionment greatly reduces the need for source rules.

[7] The practical impossibility for even the federal government of enforcing the arm's-length system is well illustrated by the I.R.S.'s recent loss of an effort to compel Chevron Corporation to label 1.3 million pages of documents it turned over to the government in a transfer pricing case. *Chevron Not Required to Label 1.3 Million Pages Turned Over to IRS*, 2 BNA Tax Management Transfer Pricing Report 135 (July 7, 1993).

[8] For an early example of where a U.K. corporation was able to pay no federal tax but nonetheless had to pay a state tax under formulary apportionment, see *Bass, Ratcliff & Gretton, Ltd. v. State Tax Comm'n*, 266 U.S. 271 (1924).

Kong, Isle of Man, Nauru, Netherlands Antilles, New Hebrides, Singapore, Turks and Caicos, Virgin Islands[9] – have much of their international tax planning nullified under WWCR. Complaints about WWCR may be nothing more than a protest against an approach that minimizes the benefits of orthodox tax avoidance techniques such as the use of transfer pricing and tax havens and results in the payment of a state tax even where no federal tax is due. For example, Barclays Bank International, Ltd. owed a California tax even though its California operations were conducted at a loss under the taxpayer's arm's length calculations.[10]

Complaints from foreign countries are neither unprecedented in the tax area nor limited to state taxation. Some foreign countries have also complained about the new transfer pricing regulations promulgated by the I.R.S.[11] Just as the lack of complaints about a state tax department may suggest a passive administration that is not aggressively countering tax avoidance, the existence of complaints may simply be a healthy sign of a well functioning tax system. A fact-intensive inquiry into the nature and motivation underlying the complaints paraded by the Petitioners is necessary before the Court can give them any significance for purposes of a dormant foreign commerce clause analysis.

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[9] See Barclays International, A World of Banking – List of Offices November 1977 (1977) 4-5.

These countries are all described as tax havens in either Anthony S. Ginsberg, Tax Havens (1991), or Hoyt L. Barber, Tax Havens: How to Bank, Invest, and Do Business – Offshore and Tax Free (1993).

[10] See Letter from Barclays to British Inland Revenue of April 14, 1986 (Tr. record, Ex. 51-V).

[11] See OECD Committee on Fiscal Affairs, *Intercompany Transfer Pricing Regulations Under U.S. Section 482 – Temporary and Proposed Regulations* (1993). Complaints by foreign governments may be raised as a courtesy to major taxpayers or industries or they may be initiated by the country itself. Most developed countries provide a credit to their taxpayers for income taxes paid to other jurisdictions. A country providing a credit has a financial stake in minimizing the tax burden imposed by other countries, especially if these other countries are not viewed as competing with it for investment.

2. No Weight Should be Given to the United Kingdom's Threats to Violate International Law

Complaints by the United Kingdom against WWCR are mentioned prominently by Petitioner Barclays because of the form in which they are embodied. The United Kingdom has threatened to deny certain benefits (the advance corporation tax, "ACT", credit) to corporations that have significant activity in a state using WWCR. The United Kingdom adopted enabling legislation in 1985,[12] but the Parliament had to give its specific approval before the retaliatory legislation could be triggered.

In 1986, British officials stated that they had not triggered the retaliatory legislation on the understanding that the United States would enact legislation abolishing WWCR before the end of the year.[13] The threat of "retaliation" was repeated two more times in 1986.[14] The threat was made again in 1988[15] and in 1993.[16] With the passage of California's legislation in 1993, discussed below, the threat has substantially been withdrawn.

These threats are the height of lawlessness and hypocrisy. In Article 10 of the U.S.-U.K. Tax Treaty, the United Kingdom agreed to provide the very ACT credits that it subsequently turned around and threatened to hold hostage in the political battle over WWCR.

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[12] Section 54 of the Finance Act of 1985, reenacted as §§ 812-815 of the Income and Corporations Taxes Act, 1988 (United Kingdom); Stephen E. Fiamma, *U.K. Retaliation Against Unitary Taxation*, 28 Tax Notes 1137 (September 2, 1985).

[13] *British MPs United in Worldwide Unitary Method Retaliation Efforts*, 31 Tax Notes 439 (May 5, 1986).

[14] Clive Holman, *MPs Threaten Retaliation Against US Unitary Tax*, Financial Times 6 (June 19, 1986); *Calling Britain's Bluff*, 300 The Economist 65 (August 2, 1986).

[15] *Retaliatory Motion to Unitary Method Introduced in Parliament*, 38 Tax Notes 592 (February 8, 1988).

[16] Sir Michael Grylls, MP, *UK Must Retaliate on CA Tax*, Financial Times 16 (May 6, 1993).

Further, its threats to violate international law[17] are in protest of WWCR, the very issue over which it received concessions during the negotiations over the treaty.[18] Such lawless action cannot be the type of justifiable retaliation by a foreign government that the Court was concerned about in *Container*. *Id.* at 194.

Apparently, the Congress agrees. The Congress has shown no interest either in counting the noses of those who have chimed in against WWCR or in genuflecting in the face of threats to violate international law.[19] Perhaps the Congress appreciates that as the economies of the world become more interlinked, state actions will inevitably raise some foreign protests. Some complaints are to be taken more seriously than others. As *Container* recognized, the nuances of U.S. foreign policy are much more the province of the Executive Branch and Congress than of this Court. *Id.* at 196. Despite complaints, Congress has refused for over twenty-five years to prohibit WWCR.[20] The Court should not now substitute its voice for that of the Congress.

[17] There is no doubt that if the United Kingdom were to deny the ACT credits, the treaty would be violated. In describing the retaliatory legislation, Assistant Secretary (Tax Policy), J. Roger Mentz stated "its actual implementation would be a clear violation of the treaty." Hearing on Review of Unitary Method of Taxation, Before the Subcomm. on Taxation and Debt Management, Senate Committee on Finance, 81 (Statement of J. Roger Mentz, Asst. Secretary, Tax Policy) (September 29, 1986).

[18] Third Protocol to the 1975 Income Tax Convention with the United Kingdom of Great Britain and Northern Ireland, as Amended, Report of the Committee on Foreign Relations, United States Senate on Executive Q, 96th Cong. 1st Sess. at 46-7 (June 15, 1979).

[19] The United States could respond to a violation by the British of Article 10 of the treaty in numerous ways. The President could terminate the treaty; or, under domestic law, the President could double the U.S. tax rate on U.K. companies up to a maximum of 80%; or increase the effective tax rates on U.K. companies to equalize them with the U.K. tax rate on U.S. companies. See IRC §§ 891 and 896. All of these options are serious, which may explain why the U.K. has never implemented its threat.

[20] *See* Hearing on H.R. 5076 Before the House Comm. on Ways and Means, 96th Cong., 2d Session, at 293-95 (statement of John S. Nolan, Counsel, on Behalf of Confederation of British Industry and the British National Comm. of the Int'l Chamber of Commerce) (March 31, 1980) for a detailed history (through 1980) of congressional consideration of, hearings on, and non-enactment of legislation that would have preempted WWCR and/or state taxation of foreign source income as it is defined by the federal government. Legislation to prohibit WWCR was introduced continuously through the 1980s in both houses and hearings were held at regular intervals. See *Hearing, supra* note 17. Preemptive legislation has been introduced at least as recently as late 1991. See S.1775, H.R. 2913, 102d Cong. 1st Sess.

3. The Executive Branch Does Not Speak for the Legislative Branch

Turning from international complaints about WWCR to domestic complaints, Petitioners remind us that former officials of the Executive branch of the federal government have been upset with the elimination of the anti-WWCR clause from the U.S.-U.K. treaty almost from the day that it was signed. Both Petitioners cite actions and statements from former Executive branch officials expressing their hostility to WWCR. But the federal government is not monolithic.[21] The issue of WWCR is not one in which the Constitution has given the President exclusive power. Power over foreign commerce is shared. The Legislative branch has the Constitutional power to regulate foreign commerce, the President has the Constitutional power to sign or veto legislation passed by the Congress, and the Congress has the Constitutional power to override a Presidential veto. The President has the Constitutional power to enter into treaties with foreign nations that might regulate foreign commerce, and the Senate has the Constitutional power to advice and consent on such treaties. This Constitutional distribution of powers does not give the President the power to preempt a state tax provision through press releases or letters.

[21] The Court has never suggested that the views of the Executive branch were to carry more weight than the views of the Legislative branch. In its dormant foreign commerce clause discussion in *Container*, the Court consistently refers to the "federal government," "federal policy," "the Executive Branch and Congress" and so forth. See *Container*, 463 U.S. at 193-196. The disproportionate emphasis placed by the Petitioners on the views of the Executive branch may reflect the Court's reference in *Container* to the lack of an *amicus curiae* brief from the Executive branch. The failure of the Executive branch to file an *amicus curiae* brief would undercut a claim that WWCR interferes with federal uniformity. The filing of such a brief, however, is merely one factor to be considered by the Court in applying a dormant foreign commerce clause analysis. *Compare Itel*, 113 S.Ct. 1095 *with Container*, 463 U.S. 159.

Otherwise, the constitutionality of WWCR could change every four years and would "emphasize transient results upon policies . . . and lose sight of enduring consequences upon the balanced power structure of our Republic." *Youngstown Co. v. Sawyer*, 343 U.S. 579, 634 (Jackson, J., concurring) (1952). Such a result would be contrary to our deeply held tradition of being a country that ascribes to the "rule of law." Fortunately, the foreign dormant commerce clause does not require that absurdity.

Understandably, the Petitioners would like to ignore the posture of the Legislative branch, which has always refused to interfere with WWCR. The Senate made its position clear at the time of the U.S.-U.K. tax treaty: "political subdivisions and local authorities of either country are free to use formula methods to apportion income, deductions, and other items among related enterprises in determining income subject to their taxes, so long as such methods do not violate the proposed treaty's nondiscrimination provisions (Article 24)."[22] The House has also expressed its position by refusing to adopt for the past 20 years bills that have been introduced that would affect WWCR.[23]

After more than two decades of debate, the Legislative branch has still refused to curtail the use of WWCR. Uniformity can hardly be characterized as "essential" if it is still lacking after all this time. Accordingly, California's use of WWCR cannot "impair federal uniformity in an area where federal uniformity is essential." *Container*, 463 U.S. at 193 (citing *Japan Line*, 441 U.S. at 448).

Finally, even a decision for Petitioners would not result in the government speaking with one voice because the Congress has indicated not only that federal uniformity is not essential but also that WWCR is permitted. The Court has, in similar contexts, recognized its limitations in imposing solutions on

[22] *Report*, *supra* note 18, at 5.

[23] See Brief for Petitioner Barclays at 9.

issues best left to the political process.[24] "It may be that 'the better part of both wisdom and valor is to respect the judgment of the other branches of the Government.' "[25]

Furthermore, California's use of WWCR is not necessarily at odds with the actions of the Reagan administration, which is the last administration to articulate a comprehensive position on WWCR. In 1983, the Reagan administration appointed a Cabinet level working group, consisting of government officials, business representatives, and ~~representatives of the~~ state governments, to study the issue.[26] The Working Group recommended that the states voluntarily adopt a water's edge limitation on combined reporting. Secretary of the Treasury Regan's final report indicated that the Group would support restrictive federal legislation if the issue was not solved within a year of the report. But if the "states enact legislation . . . agreed upon by the Working Group, the United States will be able to speak with one voice in dealing with its foreign trading partners . . . "[27]

California enacted water's edge legislation, but made it elective and imposed an election fee. This action appeased the Executive branch, which stated that "state legislative developments . . . go a long way toward resolving the difficult unitary tax issue" and "illustrate the successful operation of the

[24] "The underlying [commerce clause issue] is not only one that Congress may be better qualified to resolve, but also one that Congress has the ultimate power to resolve." *Quill Corporation v. North Dakota*, 112 S. Ct. 1904, 1916 (1992). *Quill* involved another long-standing problem of state taxation: the sales taxation of mail order sales. Despite Congress' unwillingness to adopt a federal solution to this problem, the Court refused to impose its own solution, recognizing that "Congress has the power to protect interstate commerce from intolerable or even undesirable burdens." [citations omitted]. *Id.*

[25] *Quill*, 112 S.Ct. at 1916 (citing *Commonwealth Edison Co. v. Montana*, 453 U.S. 609, 638 (1981) (White, J., concurring)).

[26] *New Unitary Approaches Mulled in Wake of Treasury Decision*, 21 Tax Notes 69-70 (October 3, 1983).

[27] Department of the Treasury, Office of the Secretary, Final Report of the Worldwide Unitary Taxation Working Group, iii (August, 1984).

Federal system."[28] The Executive branch pronounced "that restrictive Federal legislation is not warranted at this time."[29] Most recently, in 1993 California further amended its legislation, removing the election fee. California's current law satisfies the expectations of the Reagan administration.

With the election of President Clinton, the Executive branch may have shifted its voice. During the 1992 presidential campaign Governor Clinton stated " . . . a Clinton Administration will be pro-California in [the *Barclay's*] litigation."[30] Consistent with this position, the Solicitor General opposed the grant of *certiorari* in *Barclays*, citing California's recent legislative changes modifying WWCR for concluding that "[a] decision by this Court on the constitutional question posed in this case is . . . unnecessary to achieve adequate consistency in the Nation's regulation of foreign commerce, which California has striven to accomplish through its voluntary action." Brief of Solicitor General on Petition for *Writ of Certiorari* at 10. The Solicitor General also made it clear that federal uniformity is no longer essential. There has now been an "accommodation of state, national, and international interests," *id.* at 10. As of 1994, it appears that the voice of the Executive branch is more in harmony with the voice of the Legislative branch than at

[28] See *Hearing*, *supra* note 17 at 71.

[29] *Id.*

[30] John Turro, *Clinton Administration Expected to Support California in Barclays Bank Unitary Case*, 4 State Tax Notes 717-718 (March 29, 1993). This position was consistent with the President's promise to collect $45 billion of additional tax revenue over four years by "cracking down on foreign companies that prosper here and manipulate tax laws to their advantage." Governor Bill Clinton, *Putting People First: A National Economic Strategy for America*, 4, 22 (1992). It was widely believed that this revenue loss was attributed to transfer pricing abuses. For example, a former Commissioner of the Internal Revenue Service testified that "foreign controlled companies have adopted transfer pricing and other practices that may significantly understate their U.S. income tax liabilities," and that the IRS believes "the shortfall is substantial," with the "U.S. Government . . . being short-changed billions of dollars annually." Tax Underpayments by U.S. Subsidiaries of Foreign Companies: Hearings before Subcomm. on Oversight of the House Comm. on Ways and Means, 100th Cong., 2d Sess., July 10, 12, 1990, pp. 72, 73 (Statement of Fred T. Goldberg, Commissioner of the IRS). Estimates of the annual federal revenue loss from transfer pricing abuses is as high as $30 billion. *Id.*, at 262 (Statement of Rep. J. J. Pickle).

any other time in the debate over WWCR. Also, the retaliatory threat of the United Kingdom to deny treaty benefits to U.S. corporations has subsided.[31]

C. No Unconstitutional Double Taxation Exists

Under *Japan Line*, a tax is constitutionally suspect if it inevitably results in double taxation. In *Japan Line*, the same property was taxed by both Japan and California, with no established means of mitigating the overlapping assertions of taxing jurisdiction. The meaning of objectionable double taxation was obvious in *Japan Line*: two taxes on the same property with no relief mechanism. In a world in which both national and subnational governments impose income taxes, and where a long-standing custom and pattern of relief mechanisms exist internationally, the concept of objectionable double taxation is less evident. The Court in *Container* appreciated the difference between property taxes and income taxes and properly dismissed the double taxation argument in that case. Because Petitioner Barclays attempts to reopen that argument, it is worthwhile to expand on why there is no objectionable double taxation in the present case.

As this Court has recognized, double taxation already exists in the purely domestic U.S. situation. In *Mobil Oil v. Vermont*, 445 U.S. 425, 448 (1980), the Court recognized that

> "[c]oncurrent federal and state taxation of income, of course, is a well-established norm. *Absent some explicit directive from Congress*, we cannot infer that treatment of foreign income at the federal level mandates identical treatment by the States." (Emphasis added).

A corporation's income is taxed by both the federal government and the states.[32] This type of double taxation is above constitutional challenge. In other federalist countries, such as Canada, this

[31] See Brief of the Government of the United Kingdom as *Amicus Curiae* in Support of Petitioner at 21-22.

[32] The double taxation from the concurrent taxation by the United States and the states is mitigated because state income taxes are deductible in calculating the federal income tax. A few states even allow a deduction for the federal income tax in calculating the state income tax. See Richard Pomp, *The Illogical Deduction for Income Taxes Paid to Other States*, 42 Tax Law Rev. 419 (1987); Jerome R.

same pattern of unobjectionable double taxation exists between the national government and the subnational governments.

When a corporation resident in one country (the country of residence) earns income from another country (the source country), problems of double taxation can arise if no relief mechanism is provided. But in the case of income taxes, that problem tends not to occur. The custom and international practice is that the country of residence assumes the responsibility for eliminating the double taxation.[33] Most countries discharge this responsibility by either exempting foreign income (or categories thereof) or by providing a credit for income taxes paid to the source country.[34]

> "The effect of the foreign tax credit is that when the foreign tax rate is lower than the United States rate . . . a tax is paid to the United States at a rate equal to the excess of the United States rate over the foreign rate. When the foreign rate equals or exceeds the United States rate, the credit cancels United States tax liability. In short, the credit generally operates to reduce the effective over-all rate of tax to the higher of the foreign or the United States rate *and double taxation is eliminated because, in effect, only one tax is paid at the higher of the two rates.*"[35]

The credit does not eliminate the double taxation that results from the concurrent taxation by a national government and its subnational governments. This type of double taxation is the norm and outside the goal of the credit, regardless of whether a subnational government is taxing more or less income than what the national government is taxing.

For example, suppose P, a corporation, earns $100 in the source country and pays an income tax to the source country of

Hellerstein and Walter J. Hellerstein, State Taxation I: Corporate Income and Franchise Taxes (1993), 7-10.

[33] See U.S. Model Tax Treaty, Art. 23; OECD Model Tax Treaty, Art. 23.

[34] Nearly one-third of the OECD countries exempt foreign dividends received from other OECD countries. The remainder provide a foreign tax credit. See OECD, Taxing Profits in a Global Economy: Domestic and International Issues at 63 (1991).

[35] Elizabeth Owens, The Foreign Tax Credit 3 (1961) (emphasis added).

$20. Assume the country of residence also imposes a tax of $30 on this same income. Without the credit (or some other relief measure), double taxation would result because P would be paying two taxes on the same item of income. If the country of residence chooses to discharge its responsibility for relieving double taxation through the use of a credit, it would reduce the $30 of tax otherwise owed to it by the $20 paid by P to the country of source, for a net tax of $10. P pays the same amount of tax that it would have paid if all of the income had been earned in the country of residence. Any subnational income tax in the country of residence would be in addition to the national taxes – the same result that occurs in a purely domestic situation.

Double taxation might occur if a subnational government in the country of residence is taxing income that is also subject to tax by a subnational government in the source country. Without any relief, there would be one level of national tax, as in the preceding example, and two levels of subnational taxes. One way of dealing with this problem of double taxation by subnational governments, if it occurs, would be for the subnational government in the country of residence to provide a credit for the income tax of the subnational government in the country of source. The responsibility of relieving subnational double taxation, however, has been viewed as the proper responsibility of the national government, which can easily address the problem by simply extending its tax credit to include foreign subnational income taxes.[36]

Some countries, such as the United States, Canada, and the United Kingdom, have unilaterally adopted foreign tax credits that extend to subnational income taxes.[37] Other countries that might not have done so unilaterally might do so by treaty. The OECD Model Tax Treaty, for example, provides that if the country of residence chooses to relieve double taxation by a credit rather than

[36] See *Container*, 463 U.S. at 191 n. 30.

[37] In the United States, see IRC Sec. 901(b) and Treas. Reg. § 1.901-2(g)(2); in Canada, see ITA, Sec. 126(7)(a),(b); in the United Kingdom, see ICTA of 1970, Sec. 498.

by exempting foreign income, the credit extends to subnational income taxes.[38]

Barclays is not disputing California's right to impose some kind of income tax. Barclays is therefore conceding that two legitimate levels of taxes can exist: the federal income tax and the state taxes. An objectionable double tax would occur only if California and a subnational U.K. government taxed the same income. But such double taxation cannot occur because subnational governments in the United Kingdom do not levy income taxes.[39] Even if such double taxation occurred, the responsibility for alleviating it would fall on the United Kingdom as the country of residence. The essence of Barclays' objections to WWCR reduces to the fact that it may pay more under that system than under the arm's length method. But that objection may speak more to weaknesses in the arm's length method than to defects in WWCR.[40]

Moreover, it is not inevitable that WWCR produces a higher tax than would arm's length or some alternative form of taxation. There are at least two situations in which a taxpayer will be better off under WWCR than under the U.S. rules. The first involves corporations operating at a loss. WWCR allows a taxpayer to include loss corporations that have no nexus with California to be included in the combined report of the unitary business. These losses will offset income of the other corporations. The result can be that less income enters the pre-apportionment tax base than would be true if California followed the federal rules.[41]

[38] OECD Model Tax Treaty, Arts. 23B, 2(1).

[39] Andrew W. Dilnot & J.A. Kay, Tax Reform in the United Kingdom: The Recent Experience, in World Tax Reform, eds. M. Boskin and C. McLure (1990), 149-176.

[40] Residence countries that have chosen to address double taxation through the use of foreign tax credit often have complicated rules to prevent abuse or to further political goals. Complaints that Barclays might have about the British foreign tax credit are properly addressed to the British Inland Revenue and not this Court.

[41] To take a simple, straightforward example, consider a U.S. parent operating in California owning 100% of a foreign corporation, which operates abroad at a loss. Assume the U.S. parent has $100 of income and that the foreign subsidiary has $100 of losses. If the U.S. parent files a combined report with its foreign subsidiary, the $100 loss will offset the $100 gain and there will be no taxable income. By contrast under the federal rules, U.S. corporations cannot file consolidated returns with foreign corporations. The parent would be taxable by the United States on $100. If, however, the U.S. corporation were to operate abroad in the form of a branch, the foreign loss would be offset against its U.S. profits. Consequently, the choice between operating abroad as a branch or as a subsidiary has U.S. tax consequences. Under California's approach, however, the same amount of California tax would be due regardless of whether a branch or a subsidiary were used. The California method has the advantage of not making the tax a function of how a business is organized on paper. Put differently, the California fisc will not be affected by the form in which a business chooses to operate.

Second, under WWCR the apportionment percentage of the California taxpayer will reflect the payroll, property, and sales of all the members of the unitary business. The apportionment percentage of a unitary business that includes foreign corporations will likely be lower than under a water's edge approach where only U.S. corporations could be included in the combined report. The lower percentage may more than offset the increase in the pre-apportionment tax base resulting from including profitable foreign corporations.[42] Accordingly, there is no systemic bias in WWCR one way or the other.[43]

[42] To illustrate, consider a U.S. parent that owns 100% of a foreign corporation. Assume the U.S. parent has $100 of taxable income and that its subsidiary also has $100 of taxable income. If only the parent is taxable by California under a water's edge approach, assume its apportionment factor is 25%, so that it would apportion $25 to California (25% X $100). Assume further that if the foreign subsidiary were included in a combined report, the apportionment factor would decline to 5%. In a combined report, the corporation would apportion $10 to California (5% X $200). The increase in taxable income from $100 to $200 is more than offset by the decline in the apportionment percentage from 25% to 5%.

[43] Petitioner Barclays' assertion that the "underlying economic assumption [of WWCR is] that the activity of the worldwide unitary business is equally profitable in all jurisdictions," Petitioner Barclays' Brief at 24, has been rejected by this Court, as well as by scholars. See Container, 463 U.S. at 182-83; Jerome R. Hellerstein, *Federal Income Taxation of Multinationals: Replacement of Separate Accounting with Formulary Apportionment*, 60 Tax Notes 1131, at 1140-1141 (August 23, 1993); and Eric J. Coffill, *Differences in Productivity and Profitability: A Response to Allegations of the Misattribution of Income in the Application of California's Worldwide Unitary Method*, 5 Int'l Tax & Bus. Law. 246 (1987).

D. The Court Should Clarify that *Japan Line* does not Apply to Corporate Income Taxes

The globalization of the marketplace means that state tax systems will inevitably reach activities having international connections. As this case demonstrates, *Japan Line* invites endless quarrels between the states and the multinationals. If the Petitioners were to have their way, every complaint by a foreign country about a state tax can become a federal Constitutional issue. And such complaints can easily be orchestrated.

A principled distinction exists, however, between property taxes and income taxes. Unlike income taxes, there is no international custom or pattern requiring the country of residence to provide a credit for property taxes levied by other countries.[44] Moreover, Japan actually levied a property tax on the same containers that were taxed by California and did not provide a credit for foreign property taxes. *Japan Line*, 441 U.S. at 452. Consequently, double taxation existed in fact.

The recent decision in *Itel* suggests that the Court itself recognizes that *Japan Line* should not be applied if measures exist for relieving double taxation. In upholding Tennessee's sales tax on the proceeds from the lease of containers used in foreign commerce, the Court stated,

> "[f]urthermore, the foreign commerce clause cannot be interpreted to demand that a state refrain from taxing any business transaction that is also potentially subject to taxation by a foreign sovereign . . . [the Tennessee credit] reduces, if not eliminates, the risk of multiple international taxation . . . Absent a conflict with a 'consistent international practice [or] . . . federal policy,' *Container Corp.*, 463 U.S., at 190, the careful apportionment of a state tax on business transactions conducted

[44] The lack of a custom of relieving double taxation in the case of property taxes is not surprising; under the discarded "home port doctrine" there would not be multiple property taxes. Although the Court in *Japan Line* refused to rehabilitate the home port doctrine, 441 U.S. at 443, the result of the case is consistent with that doctrine.

> within state borders does not create the substantial risk of international multiple taxation that implicates foreign commerce clause concerns. . . . "

Itel, 113 S.Ct. at 1104.

The concerns the Court expressed about multiple taxation in *Japan Line* have long been addressed and remedied in the case of income taxes. At a minimum, *Japan Line* should be limited to situations of multiple taxation that the international community has not addressed.

E. *Itel* and *Wardair* Cast Doubt on the Continued Vitality of *Japan Line*

The reasoning of *Itel* and *Wardair* would have required a different outcome in *Japan Line*. *Japan Line* involved the Customs Convention on Containers, signed by both Japan and the United States. The relevant part of the Convention provided that " . . . containers temporarily imported are admitted free of 'all duties and taxes whatsoever chargeable by *reason of importation*.' " *Japan Line*, 441 U.S. at 452. In interpreting the same Convention, *Itel* makes it clear that the relevant inquiry is the reason a state imposes a tax and not the reason why the subject of the tax – the containers – are in the jurisdiction. *Itel*, 113 S. Ct. at 1100. The *Itel* Court held that the Convention prohibits only those taxes based on the act of importation itself. The Los Angeles property tax in *Japan Line* would presumably be upheld under this standard because it is not imposed on the act of importation nor is it any kind of import duty or custom duty.

Japan Line is also inconsistent with *Wardair*. In *Wardair*, the Court examined the Chicago Convention on International Civil Aviation, a Resolution by the International Civil Aviation Organization, and other bilateral agreements dealing with international aviation. None of these prohibited taxation of aviation fuel by political subdivisions, "an omission which must be understood as representing a policy choice by the contracting parties." *Wardair*, 477 U.S. at 11.

> "What all of this makes abundantly clear is that the federal government has not remained silent with

regard to the question of whether states should have the power to impose taxes on aviation fuel used by foreign carriers in international travel. By negative implication arising out of more than 70 agreements entered into since the Chicago convention, the United States has at least acquiesced in state taxation of fuel used by foreign carriers in international travel. . . . " *Id.* at 12.

By contrast, in *Japan Line* the Court characterized a convention authorizing an exemption only from duties and taxes chargeable by reason of importation, as "reflect[ing] a national policy to remove impediments to the use of containers . . . " *Japan Line*, 441 U.S. at 452. *Wardair* suggests that the Court in *Japan Line* should have inferred that the signatories had acquiesced in a property tax on containers.

From a broader perspective, *Japan Line* is an aberration. *Japan Line* was decided in 1979, just two years after the Court made clear in *Complete Auto* that it had abandoned any attempt at determining when a state tax interfered with national uniformity or imposed a direct burden on interstate commerce. Without much experience with the four tests in *Complete Auto*, perhaps the *Japan Line* Court was unwilling to abandon the old *Cooley*-type inquiries in the case of foreign commerce. The difficulty with that type of inquiry seemed to be recognized by 1983 when the Court in *Container* went to great lengths – properly so – to remove state income taxes from the *Japan Line* orbit. *Container* showed great sensitivity to the complexities that are resolved by the rational workings of WWCR. Dormant foreign commerce clause analysis is not rigorous enough to be used to annul basic taxing schemes such as WWCR. Subsequent experience with the *Complete Auto* tests should reassure the Court that the additional *Japan Line* tests are unnecessary in the case of income taxes.

II. PROHIBITING WWCR UNDER THE DORMANT FOREIGN COMMERCE CLAUSE WOULD UNDERCUT THE CONSTITUTIONAL PROTECTION OF FEDERALISM

This case presents a weak setting for the application of the dormant foreign commerce clause. The Court is not writing on a clean slate, as it has in other situations. See, e.g., *Kraft v. Iowa*, 112 S. Ct. 2365 (1992). The issue of WWCR comes to the Court with 25 years of history. In 1978, in the debate over the U.S.-U.K. tax treaty, Senator Church stated that "[f]or some ten years, Congress has been rejecting the type of limitation on the power of our State governments to tax which is incorporated in article 9(4) of the pending treaty."[45] He noted that "[t]he original purpose for the Senate's role in the treaty process was to protect the interests of the several States in treaty matters. The framers feared that to give the executive branch of the Federal Government free rein in the treaty process would enable the President to ride roughshod over the States. We may have waited a while to see that fear confirmed, but that is exactly what article 9(4) of this treaty does. It demonstrates that the fears of the framers of our Constitution were well founded."[46]

Senator Church's understanding of the constitutional structure of the government was expanded upon by the Court a few years later:

> "Apart from the limitation on federal authority inherent in the delegated nature of Congress' Article I powers, the principal means chosen by the Framers to ensure the role of the States in the federal system lies in the structure of the Federal Government itself. It is no novelty to observe that the composition of the Federal Government was designed in large part to protect the States from overreaching by Congress. [footnote omitted]. . . . " In short, the Framers chose to rely on a federal system in which special restraints on federal power

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[45] 124 Cong. Rec. Part 14, Senate pp. 18416. (June 22, 1978).

[46] *Id.* at 18417.

over the States inhered principally in the workings of the National Government itself, rather than in discrete limitations on the objects of federal authority. State sovereign interests, then, are more properly protected by procedural safeguards inherent in the structure of the federal system than by judicially created limitations on federal power. . . . we are convinced that the fundamental limitation that the constitutional scheme imposes on the Commerce Clause to protect the 'States as States' is one of process rather than one of result. . . . the principal and basic limit on the federal commerce power is that inherent in all congressional action – the built-in restraints that our system provides through state participation in federal government action. The political process ensures that laws that unduly burden the States will not be promulgated."

Garcia, 469 U.S. at 550-52, 554, 556 (1985).

To date, the political process has ensured that the federal government would not impose constraints on WWCR, thereby recognizing that the power of taxation is an essential and indisputable attribute of state sovereignty. The curtailment of WWCR has come from the voluntary action of the states at the encouragement of the Executive Branch. As the Solicitor General stated, an "accommodation of state, national, and international interests"[47] has now been reached. That accommodation was over two decades in the making and should not be upset by this Court under a dormant foreign commerce clause analysis.

Considerations of federalism also caution against destroying the diversity of experimentation in the field of state taxation. As Justice Brandeis wrote,

> "There must be power in the States and the Nation to remould, through experimentation, our economic practices and institutions to meet changing social and economic needs. . . . It is one of the happy incidents of the federal system that a single courageous State may, if its citizens choose, serve as a

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[47] Brief of Solicitor General on Petition for *Writ of Certiorari* at 10.

> laboratory; and try novel social and economic experiments without risk to the rest of the country."

New State Ice Co. v. Liebman, 285 U.S. 262, 311 (1932) (Brandeis, J., dissenting). WWCR well illustrates Justice Brandeis' wisdom.

The states were forced early in this century to cope with the problem of taxing multijurisdictional activities; in response to this challenge, they designed formulary apportionment and combined reporting. As federal officials and their counterparts around the world are becoming increasingly disillusioned with the arm's length method, they are beginning to extol the virtues of WWCR. For example, at his confirmation hearings, the Undersecretary of the Treasury for International Affairs referred to formulary apportionment as the direction in which the world will have to move.[48] Indeed, WWCR has already been suggested for use by the United States, Canada, and Mexico in the taxation of corporations operating within the North American Free Trade Zone.[49] Examining the issue of formulary apportionment for use by the European Community, a person who would become Assistant Secretary of the Treasury wrote: "Formula apportionment provides a useful and fair approximation of geographic allocation of income. This approach helps to curb tax avoidance by making it difficult to shift income away from high-tax jurisdictions. Furthermore, if a Community-wide formula were adopted, then the potential for double taxation would be mitigated. Additionally, formula apportionment simplifies tax administration, because authorities no longer need to verify

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[48] *Summers Says Formula Apportionment System Would Require Multilateral Move*, 52 BNA DAILY TAX REPORT G-6 (March 19, 1993) at G-7. Summers earlier wrote that under the federal rules, multinational firms can move profits across borders by manipulating transfer prices and by altering their means of financing. "An alternative approach is to rely on formula apportionment, which obviates the need to locate a multinational's home country and eliminates the incentive to use transfer prices to manipulate tax liabilities." See Lawrence H. Summers, *Taxation in a Small World*, in Herbert Stein, ed, TAX POLICY IN THE TWENTY-FIRST CENTURY 64, at 69, 70, 71 (1988).

[49] McIntyre and McIntyre, Using NAFTA to Introduce Formulary Apportionment, 93 TAX NOTES INTERNATIONAL 64-9 (April 5, 1993).

the transfer prices involved in separate accounting, a time-consuming and difficult process."[50]

At a recent international conference involving tax officials, academics, lawyers and OECD representatives, formulary apportionment was acknowledged as having a bad reputation, largely because of political reasons.[51] This same group of tax experts concluded that the " arm's length principle and formulary apportionment should not be seen as polar extremes . . . it is not clear where the arm's length principle ceases and formulary apportionment begins."[52] Indeed, in one of the ultimate ironies in this case, it has been reported that Barclays negotiated a transfer pricing agreement with the IRS based on formulary apportionment.[53] IRS officials have confirmed that they have completed an "advanced pricing agreement" with a foreign bank based on a three-factor formulary apportionment method employed on a worldwide basis.[54] Paradoxically, at a time when federal officials are looking to

[50] Alicia H. Munnell, *Taxation of Capital Income in a Global Economy: An Overview*, New England Economic Review 33, at 46 (September/October 1992). This article was written when Assistant Secretary of the Treasury for Economic Affairs Alicia H. Munnell was Senior Vice President and Director of Research for the Federal Reserve Bank of Boston. Her views are consistent with other scholars. See, for example, McIntyre, Harmonizing Direct Taxes in the EEC, 2 Tax Notes Int'l 131 (1990); McIntyre, Harmonizing Direct Taxes on Business within the EEC, 2 Tax Notes Int'l 341 (1990).

[51] Brian J. Arnold and Thomas E. McDonnell, *Report on the Invitational Conference on Transfer Pricing: The Allocation of Income and Expenses Among Countries*, 61 Tax Notes 1377, at 1381(December 13, 1993).

[52] *Id.*

[53] John Turro, *IRS Grants Two APAs in Derivative Products Areas*, 4 Tax Notes Int'l 959 (May 11, 1992); Gerald C. Shea, *APAs May Effectively Address Income and Expense Allocation Problems Faced by Global Trading Businesses*, 4 Tax Notes Int'l 1022 (May 18, 1992).

[54] Case example 2 in an Internal Revenue Service report on the Advanced Pricing Agreement program is "a U.S. branch of a foreign bank. The APA applied a *formulary allocation* of the net trading *profits* of the participants from their trading of derivative products on an integrated *worldwide basis*. The APA used a methodology with a *weighted three factor approach*." *See:* Robert Ackerman, et al., *The Advance Pricing Agreement (APA) Program: A Model Alternative Dispute Resolution Process*, 12 BNA Daily Report for Executives L-1 (January 19, 1994), at L-4

WWCR as part of a solution to the dilemma of arm's length pricing, the states have succumbed to political pressures and have retrenched.

The current emphasis on reinventing government has led to a new appreciation of the contributions and impact the states have had on federal policies. The experience of the states with WWCR has helped expose the practical inefficiencies and limitations with the arm's length approach and has irrevocably altered the debate over transfer pricing issues.

Out of necessity, the states have built a better mousetrap than the federal government. This mousetrap cannot be avoided by mergers and acquisitions, reorganizations, by how a business is organized on paper, or by where incorporation papers are filed, or by the setting of artificial prices in transactions between related parties. The mousetrap catches those who would use tax havens, such as Bermuda, the Cayman Islands, the Isle of Man, Nauru, the Turks and Caicos, or the Virgin Islands. The mice that get caught will squeak – and they may even get their friends to squeak and make empty threats. But these complaints cannot rise to the level of Constitutional significance without the anomalous result that the better the mousetrap, the greater the chance that the courts will release the mice.

The multinational community has led a relentless political campaign against WWCR. These efforts have forced the states to adopt voluntary limits on WWCR. Not content with this political victory, Petitioners are asking this Court to seal the laboratory doors shut so that no state could ever resurrect the method again. In an era of diminishing resources, the states need the freedom to deal with ever more complex international transactions. If the state laboratories are to be permanently closed, there should be more compelling reasons than those presented by the Petitioners.

(emphasis added). (The authors are identified as staff members of the APA Program in the IRS Office of the Associate Chief Counsel (International)). *Id.*, at L-1.

CONCLUSION

For the reasons stated above, Amicus Multistate Tax Commission urges the Court to affirm the decisions below.

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January 19, 1994

IN THE

Supreme Court of the United States

OCTOBER TERM, [illegible]

BARCLAYS BANK PLC,

Petitioner,

v.

FRANCHISE TAX BOARD,

Respondent.

COLGATE-PALMOLIVE COMPANY,

Petitioner,

v.

FRANCHISE TAX BOARD,

Respondent.

On Writ of Certiorari to the Court of Appeal [illegible]

QUESTION PRESENTED

Whether California's worldwide combined reporting method of determining the portion of the income of a unitary business attributable to its activities in California is constitutional under the foreign Commerce Clause and the Due Process Clause as applied to either a unitary group with a foreign parent (Barclays) or a unitary group with a domestic parent (Colgate-Palmolive).

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BRIEF OF THE COUNCIL OF STATE GOVERNMENTS, NATIONAL GOVERNORS' ASSOCIATION, U.S. CONFERENCE OF MAYORS, INTERNATIONAL CITY/COUNTY MANAGEMENT ASSOCIATION, NATIONAL LEAGUE OF CITIES, NATIONAL ASSOCIATION OF COUNTIES, AND NATIONAL CONFERENCE OF STATE LEGISLATURES AS *AMICI CURIAE* IN SUPPORT OF RESPONDENT

INTEREST OF THE *AMICI CURIAE*

Amici, organizations whose members include state, county, and municipal governments and officials throughout the United States, have a compelling interest in legal issues that affect state and local governments. Among the most important of such issues are those raised by federal limitations on state and local taxing authority. The petitions in these two cases raise constitutional challenges under the foreign Commerce Clause and the Due Process Clause to California's worldwide combined reporting method of taxation. With more than $2 billion in tax revenues at stake in California alone (Colg. Supp. Br. on Petition 4, Resp. Op. Cert. Colg. 15), this case presents a grave challenge to the existing tax schemes, revenue-raising powers, fiscal health and legislative discretion of state governments. *Amici* have a vital interest in seeing that this threat is turned back and the decisions below affirmed.[1]

STATEMENT

These cases involve the application of two methods of determining the portion of the income of a unitary multinational business attributable to its activities in a taxing jurisdiction. The two methods are worldwide combined reporting (WWCR), which is a type of formulary

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[1] The parties' letters of consent to the filing of this brief have been filed with the Clerk pursuant to Rule 37.3 of the Rules of this Court.

apportionment, and arm's length/separate accounting (AL/SA).

Under WWCR, as applied by California in the income years in question (1970-1973 and 1977), once a multinational business has been determined to be unitary (*i.e.*, operating as a single economic enterprise, even though divided into many subsidiaries or branches), the multinational is treated as one unit and the portion of its income attributable to California is determined based on a formula that takes into account the taxpayer's capital (property), labor (payroll), and the use of the market (sales) in California compared to the same factors on a worldwide basis. Pet. Br. Colg. 5-6.

Under AL/SA, instead of treating the unitary group as a single business, each separate subsidiary or branch of the multinational group is treated as if it were an independent enterprise dealing with all other units of the multinational group on an arm's length basis. *Id.* at 4-5.

Both petitioners have conceded that their operations in California (directly by the parent in the case of Colgate, and through a separate subsidiary (Barcal) and a branch of a U.K. corporation (BBI) in the case of Barclays) were part of single unitary businesses which included all other corporations in their controlled groups (approximately 220 corporations in the case of Barclays, and approximately 75 corporations in the case of Colgate). *Id.* at 4; Pet. Br. Barc. 3.

Barclays filed its income tax returns in California, with Barcal filing a separate accounting return and BBI filing a worldwide combined return for itself and all of its U.S. and foreign subsidiaries, including Barcal. Pet. Br. Barc. 11-12. Colgate filed its California return for the parent only, excluding its foreign subsidiaries. Pet. Br. Colg. 10. On audit, the California Franchise Tax Board determined (as petitioners here concede) that both petitioners constitute unitary businesses and therefore should file combined returns for their entire worldwide unitary groups. *Id.*; Pet. Br. Barc. 11. This change in method

of filing resulted in more of petitioners' income being attributed to California. Pet. Br. Colg. 10; Pet. Br. Barc. 11-12.

Petitioners now challenge the resulting increase in their tax burden on constitutional grounds, arguing that WWCR violates the foreign Commerce Clause and (in the case of Barclays) the Due Process Clause. Thus, petitioners argue that the Constitution mandates that California use AL/SA in taxing either a multinational unitary group with a foreign parent (Barclays) or a multinational unitary group with a U.S. parent (Colgate).

INTRODUCTION AND SUMMARY OF ARGUMENT

Petitioners' arguments depend on their portrayal of WWCR as a radical method used by California that is the antithesis of the arm's length method used by the federal government and the rest of the world. Pet. Br. Barc. 16; Pet. Br. Colg. 4-6. In reality, however, arm's length and WWCR approaches are not incompatible opposites, as petitioners would have this Court believe, but are part of a continuum. At a recent conference, both proponents and opponents of WWCR from the international community agreed that

> the arm's length principle and formulary apportionment should not be seen as polar extremes; rather, they should be viewed as part of a continuum of methods ranging from [comparable uncontrolled prices] to predetermined formulas. It is not clear where the arm's length principle ceases and formulary apportionment begins, and it is counterproductive and unimportant to attempt to apply labels to the methods.

Brian J. Arnold and Thomas E. McDonnell, *Report on the Invitational Conference on Transfer Pricing: The Allocation Of Income And Expenses Among Countries*, 61 Tax Notes 1377, 1381 (December 13, 1993).

Formulary methods similar to WWCR are commonly used in conjunction with the arm's length method by the

federal government and other countries. In recent decades, the federal income tax rules relating to the allocation of income in the international context have been evolving under the pressure of economic reality away from a pure arm's length approach based on comparable transactions, to a combination of comparable transactions and formulary approaches in the absence of comparables. *See e.g.*, 26 U.S.C. § 863(b); 26 C.F.R. § 1.863-3T(b). In this context, the United States is leading the world toward a new consensus that arm's length and formulary approaches are both parts of an acceptable continuum of methods.

The federal government's resort to formulary methods in conjunction with arm's length arises out of a central flaw in the arm's length approach which precludes its use in "pure" form. Indeed, Professor Langbein has commented that, because of these flaws, "arm's length, defined as the antithesis of fractional apportionment, not only is not a norm, it is not even meaningfully a concept." Stanley I. Langbein, *The Unitary Method and the Myth of Arm's Length,* 30 Tax Notes 625, 655 (February 17, 1986).

The arm's length method seeks to allocate the profits of each member (or branch) of a unitary group "as if those profits were earned by a separate enterprise." Barc. Petition 5. The obvious problem with this approach is that in the absence of actual comparable transactions between unrelated enterprises, it is often impossible to reconstruct what the hypothetical profits of the related enterprises should be. As this Court has recognized, the failure of separate geographic accounting to account for "factors of profitability [which] arise from the operation of the business as a whole" makes it "misleading to characterize the income of the business as having a single identifiable 'source.'" *Mobil Oil Corp. v. Commissioner of Taxes of Vt.*, 445 U.S. 425, 438-39 (1980).

This problem led the federal courts, in a series of cases beginning in the 1970s, to apply a variety of formulary

methods to allocating the profits of the related enterprises. The federal government, which has long used formulary methods in combination with arm's length, formalized its use of this approach in 1993 with the issuance of temporary regulations applying a formulary approach in the absence of comparable arm's length transactions. *See* Intercompany Transfer Pricing Regulations Under Section 482, 58 Fed. Reg. 5310 (1993) (codified at 26 C.F.R. §§ 1.482-0T through 7T) ("temporary regulations").

Once the false dichotomy between WWCR and arm's length (as applied by the federal government) is exposed, petitioners' arguments crumble. It becomes clear that California's taxation method is permissible under this Court's foreign Commerce Clause [2] and Due Process Clause precedents.

1. As enunciated in *Japan Line, Ltd. v. County of Los Angeles,* 441 U.S. 434 (1979), and elaborated in *Container Corporation of America v. Franchise Tax Bd.*, 463 U.S. 159 (1983), the foreign Commerce Clause requires that a state tax scheme implicating international commerce meet two tests: first, it must not prevent the federal government from "'speaking with one voice' in international trade," *Container,* 463 U.S. at 193 (quoting *Japan Line,* 441 U.S. at 453), and, second, it must not result in international multiple taxation that can reasonably be eliminated by the State. *Container,* 463 U.S. at 189-90.

California's formulary method does not violate the "one voice" requirement of the foreign Commerce Clause because it is consistent with the method applied by the federal government itself in apportioning the income and deductions of corporations engaged in international commerce.

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[2] The Franchise Tax Board argues that because Congress has acted to permit it to use WWCR, dormant Commerce Clause analysis is inapplicable to this case. *Amici* agree. However, to avoid duplicating respondent's extensive treatment of this issue, this brief will focus on demonstrating the constitutional validity of California's WWCR methodology, even assuming that dormant Commerce Clause analysis is applicable.

In fact, the federal government applies formulary approaches, in conjunction with the arm's length method, to U.S. branches of foreign corporations (including banks, such as BBI), to foreign corporations controlled by U.S. parents (such as Colgate and its subsidiaries), and to U.S. subsidiaries of foreign parents (such as Barcal); by international consensus, those formulary approaches do not violate the tax treaties entered into by the federal government. *See* Louis M. Kauder, *The Unspecific Federal Tax Policy of Arm's Length: A Comment On The Continuing Vitality of Formulary Apportionment At The Federal Level*, 60 Tax Notes 1147 (Aug. 29, 1993).

Moreover, in the context of allocating profits between a foreign corporation and its U.S. branch, the federal government has used a formulary approach virtually identical to California's since 1922. *See Intel Corp. and Consolidated Subsidiaries v. Comm'r*, 100 T.C. No. 39 (June 28, 1993), *reprinted in* BNA Daily Tax Report, June 29, 1993 at K-5, K-7–K-8, 1993 U.S. Tax Ct. LEXIS 38 (citing 42 Stat. 227, 244-45 (1921); Regs. 62, art. 327 (1922)). These methods are fully compatible with the arm's length approach and have achieved international acceptance. Thus, this Court should not hold that WWCR violates the "one voice" prong of the foreign Commerce Clause, since the federal government itself uses formulary methods akin to WWCR ubiquitously in its international tax régime.

2. In addition, as this Court held in *Container*, WWCR does not violate the multiple taxation prong of the foreign Commerce Clause because it does not pose more risk of multiple taxation than the arm's length method, as applied by the federal government. *See Container*, 463 U.S. at 191. Developments in the federal tax arena since 1983, when *Container* was decided, have dramatically demonstrated that "California would have trouble avoiding double taxation even if it adopted the 'arm's length' approach" as it is applied by the United States and interpreted by the courts under 26 U.S.C. § 482. *Container*, 463 U.S. at 192. In fact, the International Chamber of Commerce, in commenting on the recently issued temporary regulations implementing the federal approach to this issue under 26 U.S.C. § 482, has stated that the regulations "will inevitably lead to double taxation." Letter of International Chamber of Commerce of 4/22/93, ¶ 21, *reprinted in International Chamber of Commerce Attacks New Transfer Pricing Regs.*, Tax Notes Today, 93 TNT 113-24 (May 27, 1993).

3. California's WWCR does not violate the Due Process Clause because it is no more burdensome or arbitrary than analogous federal provisions, which have not been challenged on due process grounds. California does not impose a heavier burden on U.S. subsidiaries of foreign parents, such as Barcal, than is already imposed on domestic corporations that are 25 percent or more foreign-owned (under 26 U.S.C. § 6038A and the regulations thereunder) or for U.S. branches of foreign corporations, such as BBI (under 26 U.S.C. § 6038C). Nor are the standards used by California in applying WWCR any more vague or capricious than the standards used by the federal government under the corresponding provision of federal tax law, 26 U.S.C. § 482, which was first enacted in substantially its present form in 1928. Hence, WWCR cannot be invalidated on due process grounds without casting a heavy shadow over analogous, generally accepted provisions of federal tax law.

ARGUMENT

I. CALIFORNIA'S FORMULARY METHOD DOES NOT VIOLATE THE FOREIGN COMMERCE CLAUSE

Petitioners' contention that California's use of WWCR violates the foreign Commerce Clause is premised on two core arguments: first, that WWCR prevents the federal government from "'speaking with one voice' in international trade," and, second, that it results in international multiple taxation that can reasonably be eliminated by the use of arm's length. Each of these arguments is meritless.

Petitioners' one voice argument depends on their depiction of WWCR as an idiosyncratic tax system that is "separate and different" from, and "incompatible with," the "international standard" of arm's length. Pet. Br. Barc. 16. This reductionist portrayal is irreconcilable with reality. Formulary apportionment is not idiosyncratic and has been repeatedly upheld by this Court. *See, e.g., Bass, Ratcliff & Gretton, Ltd. v. State Tax Comm'n*, 266 U.S. 271 (1924); *Mobil Oil*, 445 U.S. at 438-40; *Container*, 463 U.S. at 197. Equally important, formulary apportionment and arm's length are not, as petitioners would have this Court believe, polar opposites, but are part of a continuum. *See, e.g.*, Arnold & McDonnell, *Report on the Invitational Conference*, 61 Tax Notes at 1381. Indeed, as employed by the federal government, arm's length commonly uses formulary components. There is no basis for petitioners' assertion that California prevents the federal government from speaking with one voice, because the federal government uses formulary methods ubiquitously in its international tax regime.

Petitioners' multiple taxation argument is likewise unavailing. WWCR does not violate the multiple taxation prong of the foreign Commerce Clause because it does not pose more risk of multiple taxation than the arm's length method as applied by the federal government.

The errors in petitioners' analysis of these two issues flow from a common source. As *amici* show immediately below, the inherent limitations of the arm's length method as applied to multinational parents and subsidiaries routinely compel taxing authorities, including the United States, to use elements of formulary apportionment in conjunction with tax systems denominated "arm's length."

A. The Basic Theoretical Weaknesses Of The Arm's Length Approach, Recognized By This Court, Require Resort To Formulary Methods

In upholding the constitutional validity of formulary apportionment, the Court has repeatedly emphasized the theoretical failings inherent in the arm's length method.

In *Mobil Oil*, and again in *Container*, the Court explained that

> separate [geographical] accounting, while it purports to isolate portions of income received in various States, may fail to account for contributions to income resulting from functional integration, centralization of management, and economies of scale. Because these factors of profitability arise from the operation of the business as a whole, it becomes misleading to characterize the income of the business as having a single identifiable "source." Although separate geographical accounting may be useful for internal auditing, for purposes of state taxation it is not constitutionally required.

Mobil Oil, 445 U.S. at 438 (internal citation omitted), *quoted in Container*, 463 U.S. at 181; *see also Trinova Corp. v. Michigan Dept. of Treasury*, 498 U.S. 358, 378 (1991); *Amerada Hess Corp. v. Director, Div. of Taxation*, 490 U.S. 66, 74 (1989). It is not possible to determine accurately the income of each component of a unitary business on a separate, geographic basis because, as the Court has observed, the underlying profit figures "are based on precisely the sort of formal geographical accounting whose basic theoretical weaknesses justify resort to formula apportionment in the first place." *Container*, 463 U.S. at 181; *see also* Jerome R. Hellerstein, *Federal Income Taxation of Multinationals: Replacement of Separate Accounting With Formulary Apportionment*, 60 Tax Notes 1131, 1140-41 (August 23, 1993).[3]

"[S]licing a shadow," as the *Container* Court called the attempt to allocate the income of a unitary group geographically, 463 U.S. at 192, does not become any easier if the unitary group, as in this case, crosses national as well as state boundaries. A simple example illustrates the problem.

[3] The Court's reasoning defeats Barclays' argument (Pet. Br. Barc. 24) that formulary methods erroneously assume equal profitability of all portions of the unitary enterprise. Formulary methods are necessary precisely because there is no way of establishing accurate profit figures for each component of a unitary enterprise.

Suppose foreign parent (FP) manufactures a widget at a cost of 50 and sells it to domestic subsidiary (DS) which resells it for 100. If DS has marketing costs of 20, it would have a profit if it bought the widget for any price below 80, while FP would have a profit if it sold the widget for any price above 50. The interval, between 50 and 80, represents a potential profit continuum, and the related parties can split it in any way they wish and still each make a profit. In the absence of comparable transactions with unrelated taxpayers, it is virtually impossible to definitively allocate the profit of 30 to either party.

Ordinarily, one could attempt to split the profit based on the economic functions performed by the parties. In the context of a unitary group, however, there is an additional economic reality that complicates this task: Like any organization, unitary groups exist because of market and non-market advantages that are derived from their structure. *See, e.g.*, J. Hellerstein, *Federal Income Taxation of Multinationals*, 60 Tax Notes at 1135-36. Thus, even if one applies a market rate of return separately to each of the components of the unitary group, the result is less than the actual return of the organization as a whole. The synergistic interaction among the constituent parts of the organization results in a residual that cannot be assigned to any separate geographic component.[4]

Any rule that arbitrarily assigns this residual to a member of the group distorts economic reality, because there is no single correct arm's length result. *See* H.R. Rep. 426, 99th Cong., 1st Sess., 423-24 (1985) ("A recurrent problem is the absence of comparable arm's length transactions between unrelated parties, and the inconsistent results of attempting to impose an arm's length concept

[4] If there is a large residual resulting from the advantages afforded by the group's unitary structure, that same residual drives competitors out of the market, making comparables even less likely to be found. *See* Stanley I. Langbein, *The Unitary Method and the Myth of Arm's Length*, 30 Tax Notes 625, 654-55, 666-69 (February 17, 1986).

in the absence of comparables.") (footnotes omitted); David R. Tillinghast, *An American View of International Intercompany Pricing Problems, in* 1979 Conference Report: Report of the Proceedings of the Thirty-First Tax Conference 469, 476 (Canadian Tax Foundation 1980) (where comparable uncontrolled transactions do not exist, "the plain fact . . . is that there is no such thing as an arm's-length price"), *quoted in* J.A. 827 (trial testimony of Tillinghast as Barclays' expert witness).[5]

In a long series of cases since 1980, this problem has bedevilled the federal courts in their attempts to deal with transfer pricing issues under 26 U.S.C. § 482 in the absence of comparables. The result has been a series of stupendously long, fact-based opinions in which the courts eventually split the residual profit between the related parties based on some vague understanding of their respective functions. Judge Tannenwald recently described the dilemma the Tax Court faces in making allocation decisions in Section 482 cases as a task that is "most difficult to perform in light of the [c]ourt's inevitable lack of knowledge of the realities of the workings of a specific industry and of the business world generally, including particularly the international competitve atmosphere which those realities reflect." *Perkin-Elmer Corp. v. Comm'r*, T.C. Memo 1993-414, 1993 Tax Ct. Memo LEXIS 424 at 97-98 (Sept. 8, 1993). The court must nevertheless find "precise answers based on an imprecise record," *id.* at 98, usually by "find[ing] a middle ground—a task which

[5] *See also* J.A. 829 (expert testimony of Tillinghast) ("the basis on which [the] division of profit is made varies according to the judgment of the auditing agent and the IRS as to what would produce a reasonable approximation of what an arm's-length price would be"); Langbein, *The Unitary Method*, 30 Tax Notes at 654-55; Dale W. Wickham & Charles J. Kerester, *New Directions Needed for Solution of the International Transfer Pricing Tax Puzzle: Internationally Agreed Rules or Tax Warfare?*, 56 Tax Notes 339, 345-47 (July 20, 1992); U.S. General Accounting Office, GAO/GGD-92-89, *International Taxation: Problems Persist in Determining Tax Effects of Intercompany Prices* 60-62 (June 1992).

it has disavowed, in other contexts." *Id.* (citation omitted). "The task thus thrust upon us is," he wrote, "to put it mildly, frustrating." *Id.* at 96. *See also Hospital Corporation of America v. Comm'r,* 81 T.C. 520, 596-97, 601 (1983) (noting "the lengthy and inconclusive record" but finding "as a fact that 75 percent of the taxable income of LTD in 1973 was attributable to petitioner"); *Eli Lilly & Co. v. Comm'r,* 84 T.C. 996, 1191 (1985), *aff'd in part and rev'd in part,* 856 F.2d 855 (7th Cir. 1988); *G.D. Searle & Co. v. Comm'r,* 88 T.C. 252, 376 (1987) ("best judgment" allocation of profit); *Sundstrand Corp. v. Comm'r,* 96 T.C. 226, 375 (1991) ("best estimate" by court of appropriate transfer price).[6]

Alternatively, to avoid such "rough justice" approximations, the federal courts have strained to find comparables where no economic comparables exist. Thus, in *United States Steel Corp. v. Comm'r,* 617 F.2d 942, 951 (2d Cir. 1980), the court of appeals found that a comparable existed despite widely different volume and risks, even though it realized that the result did not reflect "economic reality." A similar outcome was reached in *Bausch & Lomb, Inc. v. Comm'r,* 92 T.C. 525 (1989), *aff'd,* 933 F.2d 1084 (2d Cir. 1991). The Tax Court held that a comparable was valid despite the extremely different economic conditions existing between the related parties, and the court of appeals affirmed, reasoning that such differences "will always be the case when transactions between commonly controlled entities are compared to transactions between independent entities." 933 F.2d at 1091.

This burgeoning series of cases, which threatens to overwhelm the IRS and the Tax Court,[7] has led to increasing

[6] In the United States Claims Court (and its predecessor, the Court of Claims), the result has been one-sided victories for either side. *Compare E.I. Du Pont De Nemours & Co. v. United States,* 608 F.2d 445 (Ct. Cl. 1979), *cert. denied,* 445 U.S. 962 (1980), *with Merck & Co., Inc. v. United States,* 24 Cl. Ct. 73 (1991).

[7] "For the foreseeable future, transfer pricing litigation will place a heavy burden on the Service and the Tax Court." U.S.

criticism by the General Accounting Office and by Congress of AL/SA as applied at the federal level. *See* U.S. General Accounting Office, GGD-81-81, *IRS Could Better Protect U.S. Tax Interests in Determining the Income of Multinational Corporations* (Sept. 30, 1981); H.R. Rep. 426, 99th Cong., 1st Sess. 423-25 (1985). The Conference Report on the 1986 Tax Reform Act instructed the IRS to conduct a study of the problem and to consider carefully "whether the existing regulations [implementing AL/SA] could be modified in any respect." H.R. Rep. 841, 99th Cong., 2d Sess. II-638 (1986), *reprinted in* 1986 U.S.C.C.A.N. 4075, 4726. The result of these criticisms has been, first, a lengthy study by the Treasury Department recommending significant changes to AL/SA, Notice 88-123, 1988-2 C.B. 458 (the "White Paper"); second, proposed regulations with additional changes; and finally, in January 1993, the adoption of temporary regulations which significantly modify AL/SA at the federal level. 58 Fed. Reg. 5310 (1993) (codified at 26 C.F.R. § 1.482-0T through 7T). The most significant change in these temporary regulations is the express incorporation of formulary approaches into AL/SA in the absence of exact comparables. *See id.* at § 1.482-5T. As discussed immediately below, this is only the most recent development in the United States' long-standing use of formulary methods in conjunction with arm's length.

Treasury and IRS, *Report on the Application and Administration of Section 842* at 6-3 (April 9, 1992), *reprinted in* BNA Special Supplement 2, Report No. 70 at S-34 (April 10, 1992) (bound with BNA Daily Tax Report) (hereinafter "Treasury and IRS Report"); *cf.* GAO, *International Taxation* at 47 ("transfer pricing cases in general can be very burdensome, time-consuming, and expensive for the courts, IRS, and the companies involved").

In recent transfer pricing litigation under Section 482, Chevron produced 1.3 million pages of unlabelled documents to the IRS. *See Chevron Not Required to Label 1.3 Million Pages Turned Over To The IRS,* BNA Tax Management, Transfer Pricing Report, at 135-36 (July 7, 1993).

B. California's Method Does Not Violate The "One Voice" Requirement Of The Foreign Commerce Clause Because The Federal Government Uses Formulary Apportionment Itself In Conjunction With The Arm's Length Method

1. *The Federal Government Uses Formulary Apportionment In Conjunction With Arm's Length*

Petitioners' entire "one voice" argument is based on a false dichotomy between the "pure" AL/SA allegedly used by the federal government and other countries, and WWCR. *See, e.g.*, Pet. Br. Barc. 4-5, 16. However, the federal government—like other nations—does not adhere to pure AL/SA; instead, it commonly uses a combination of AL/SA and formulary approaches. Once this is recognized, the key assumption underlying petitioners' "one voice" argument crumbles. For why should California be forced to change its taxing method to comply with a single federal voice, when that voice itself uses methods similar to California's?

As this Court recognized in *Container*, AL/SA as applied by the United States is neither pure nor simple. It is a "qualified" arm's length approach under which every corporation is treated "for most—but decidedly not all—purposes as if it were an independent entity." 463 U.S. at 184-85. And there are "elaborate regulations" implementing the ability of the IRS to "'distribute, apportion or allocate gross income'" among related taxpayers under 26 U.S.C. § 482. 463 U.S. at 190-91 (quoting 26 U.S.C. § 482).

Since *Container*, there have been significant developments in this area that have further modified AL/SA as applied by the federal government. These developments have led a group of experts—including senior officials of the U.S. Treasury, U.K. Inland Revenue, the Fiscal Affairs Division of the OECD, and the Japanese National Tax Administration—to conclude recently that "the arm's length principle and formulary apportionment should not be seen as polar extremes" and that "it is not clear where the arm's length principle ceases and formulary apportionment begins." Arnold and McDonnell, *Report on the Invitational Conference*, 61 Tax Notes at 1381 (December 13, 1993).

The easiest case to show that the federal government uses formulary approaches is the taxation of a U.S. branch of a foreign corporation, such as BBI. Since the Revenue Act of 1921, the Internal Revenue Code has included a provision like 26 U.S.C. § 863(b), which states:

> In the case of gross income derived from sources partly within and partly without the United States, the taxable income may first be computed by deducting the expenses, losses, or other deductions apportioned or allocated thereto and a ratable part of any expenses, losses or other deductions which cannot definitely be allocated to some item of gross income; and the portion of such taxable income attributable to sources within the United States may be determined by processes or *formulas of general apportionment* prescribed by the Secretary.

26 U.S.C. § 863(b) (emphasis added).[8]

Regulations for the sale of personal property were promulgated under this section in 1922 and remain essentially unchanged today. *Intel*, 100 T.C. No. 39, BNA Daily Tax Report, June 29, 1993 at K-8 & n.4 (quoting Regs. 62, art. 327 (1922)). Operation of these regulations involves three examples, two of which are pertinent here: Example 1, which applies an arm's length methodology and Example 2, which employs a formulary approach. *See* 26 C.F.R. §§ 1.863-3(b)(2), Example 1 and 1.863-3T(b)(2), Example 2.[9]

Example 1 applies only if the taxpayer "regularly sells part of his output to wholly independent distributors or

[8] *See* Revenue Act of 1921, ch. 136, 42 Stat. 227, 244-45 (1921). The history of 26 U.S.C. § 863(b) is described in *Intel Corp. v. Comm'r*, 100 T.C. No. 39, BNA Daily Tax Report, June 29, 1993 at K-7—K-8.

[9] Example 3 allows the taxpayer to apply "for permission to base the return upon the taxpayer's books of account." 26 C.F.R. § 1.863-3(b)(2), Example 3.

other selling concerns in such a way as to establish fairly an independent factory or production price," *i.e.*, if there is an independent arm's length transaction. *See* 26 C.F.R. § 1.863-3(b)(2), Example 1. Under rules promulgated by the IRS, it is exceedingly hard to find an "independent factory price" (IFP) under Example 1. The IFP must be derived from sales of the same manufacturer (not unrelated comparables) which are regular and substantial, must involve a wholly independent distributor, must not involve significant income-generating activity of the taxpayer other than manufacturing, and must reasonably reflect the income from manufacturing. Notice 89-10, 1989-1 C.B. 631-32.

In the many instances in which Example 1 is inapplicable, the IRS and the taxpayer generally must apply the method set forth in Example 2. Under Example 2, the annual taxable income attributable to sales of property produced abroad and sold in the United States is first split in half; then, the 50% allocated to manufacturing is apportioned between the U.S. and the foreign jurisdiction based on a property factor, and the 50% allocated to sales is apportioned based on a sales factor. 26 C.F.R. § 1.863-3T(b)(2), Example 2.[10] This method of apportionment is substantially similar to the formulary apportionment employed by California, except that payroll is not a factor and the federal sales factor is more open to manipulation because the location of sales is based on passage of title (a fact wholly within the taxpayer's control) and not on destination. *Compare* 26 C.F.R. § 1.863-3T(b)(2) and § 1.861-7(c) *with* Cal. Rev. & Tax Code § 25135.

Given the constraints on the use of Example 1, it is not surprising that the courts have repeatedly rejected IRS attempts to force taxpayers to use Example 1 rather than the formulary method of Example 2. *See, e.g., Phillips*,

[10] For an explanation of how Example 2 is applied, *see Phillips Petroleum Co. v. Comm'r*, 101 T.C. No. 6 (July 27, 1993), BNA Daily Tax Report, July 28, 1993 at K-5, 1993 U.S. Tax Ct. LEXIS 47.

101 T.C. No. 6, and *Intel*, 100 T.C. No. 39. Thus, for the substantial number of foreign unitary groups engaged in the manufacture of tangible property abroad and its sale in the U.S. through a branch, the federal government applies a formulary method highly similar to California's in the vast majority of cases.

Moreover, it should not be overlooked that the California business of BBI is not just a branch of a foreign corporation—it is a branch of a foreign bank. One of the most important activities of banks is accepting funds on deposit, and thus one of the most important determinants of their income is the allocation of interest expense. The federal government has recognized that because interest is fungible, the interest expense of branches must be apportioned based on a formula that takes into account the worldwide interest expense of the foreign taxpayer, and this method has been applied specifically to U.S. branches of foreign banks. Under 26 U.S.C. § 882(c), deductions allocated to foreign corporations engaged in a U.S. trade or business are apportioned and allocated under regulations prescribed by the Treasury. Under the relevant regulations, BBI's deductible interest expense in the U.S. is calculated based on a formula that compares BBI's U.S. assets to a ratio based on its worldwide assets and liabilities. 26 C.F.R. § 1.882-5(b). This formula is based on the same theoretical underpinnings as WWCR—that it is impossible to allocate income and expense among the parts of a unitary business based on pure AL/SA.

In the case of subsidiaries of a U.S. parent such as Colgate, the situation is slightly more complex. In this context the U.S. generally does not need to apply formulary methods because it has adopted a more extreme solution: Since 1962, the U.S. has considered it entirely legitimate to include the *entire* income of "controlled foreign corporations" such as Colgate's subsidiaries in the annual taxable income of their U.S. parent as a deemed dividend. *See* 26 U.S.C. §§ 951-960. This proposal, originally made by the Kennedy administration, was subsequently modified to include only certain types of income

in the U.S. parent's income currently, and to permit deferral of tax for other types. *See* S. Rep. No. 1881, 87th Cong., 2d Sess. (1962), *reprinted in* 1962 U.S.C.C.A.N. 3304, 3381-83; Revenue Act of 1962, Pub. L. No. 87-834 § 12, 76 Stat. 960, 1006-27 (1962). But this privilege of deferral, granted for competitiveness reasons, has been steadily eroded and in the most recent tax act has been substantially limited, based on a formula that considers the foreign corporation's passive versus active assets. *See* Omnibus Budget Reconciliation Act of 1993, Pub. L. No. 103-66, 107 Stat. 312, 496-501 (August 10, 1993) (to be codified at 26 U.S.C § 956A) In any case, it has not been suggested that the U.S. is breaching an international consensus in currently taxing controlled foreign corporations, and there are recurrent proposals to end deferral altogether with no objection from abroad. *See, e.g.*, Foreign Income Tax Rationalization & Simplification Act of 1992, H.R. 5270, § 201, 102d Cong., 2d Sess. (1992). Clearly, it is much more drastic to allocate the entire income of *all* controlled foreign corporations to the U.S. than to apply WWCR to a domestic parent unitary group, such as Colgate.

Even under the classic arm's length situation, that of a U.S. subsidiary of a foreign parent (such as Barcal), the federal government applies a formulary approach in a large number of cases. This is the result of the reexamination of the regulations under 26 U.S.C. § 482 which was described above (at p. 13), which culminated in the current temporary regulations under that section.

As a preliminary matter, it is necessary to recognize that 26 U.S.C. § 482 itself, which has not been significantly changed since 1928, does not mandate the use of AL/SA or bar the use of WWCR: all it does is state that in the case of affiliated organizations, "the Secretary may distribute, apportion, or allocate income, deductions, credits, or allowances between or among such organizations" if necessary to clearly reflect their income. The actual apportionment can be done by pure AL/SA, pure WWCR, or any method in between.

In fact, under the current temporary regulations, if there is no comparable transaction the Secretary may base his § 482 adjustment on the "comparable profits method." This approach constructs a formula based on the profits of comparable, unrelated taxpayers and forces the related parties to adjust their transactions so that their profits fall within the comparable "arm's length" range of profits constructed by the formula. 26 C.F.R. § 1.482-5T.[11] This formula is used in a broad range of cases. Under a "best method rule" provided in the regulations, the formula will be applied when there is no exact comparable to be found, *i.e.*, in the majority of cases in which disputes arise between taxpayers and the IRS. *See* 26 C.F.R. § 1.482-1T(b)(2)(iii); James P. Fuller and Ernest F. Aud, Jr., *The New Temporary and Proposed Section 482 Regulations: A Wolf in Sheep's Clothing?*, 6 Tax Notes Int'l 525 (March 1, 1993).[12]

2. *The Federal Government's Use of Formulary Methods In Conjunction With Arm's Length Does Not Violate Its Treaty Obligations*

The federal government thus applies formulary methods, in conjunction with AL/SA, to U.S. branches of foreign corporations (BBI), to foreign subsidiaries of U.S. parents (Colgate), and to U.S. subsidiaries of foreign parents (Barcal). Why, therefore, has there not been an outcry of protest by foreign governments that the U.S. is violating its tax treaties? Because, contrary to petitioners' suggestions, *see* Pet. Br. Barc. 4-6; Pet. Br. Colg. 4-5, the use of formulary methods to apportion income

[11] The formula relies on "profit level indicators" that include ratios of profit to operating assets, costs (*e.g.*, payroll), and sales, *i.e.*, the same factors California uses. 26 C.F.R. § 1.482-5T(e). *See also* Proposed Regulation § 1.482-6, 58 Fed. Reg. 5310, 5311 (Jan. 21, 1993) (proposing a profit split method based on a formula that incorporates an assets factor).

[12] The use of such formulas in the new temporary and proposed regulations is but an implementation, delayed by over 30 years, of a congressional request to the Treasury Department to develop "formulas" for the application of 26 U.S.C. § 482. *See* H.R. Rep. 2508, 87th Cong., 2d Sess. 18-19 (1962).

and expenses on a worldwide basis, in conjunction with AL/SA, is fully compatible with the treaty obligations of the United States.[13]

First, let us look at the treaty rule on branches, or "permanent establishments," which is Article 7(2) of the U.S. Model Treaty. In *Container*, this Court cited the branch rule as "requir[ing] the Federal Government to adopt some form of 'arm's-length' analysis in taxing the domestic income of multinational enterprises." 463 U.S. at 196. The branch rule states:

> Subject to the provisions of paragraph 3, where an enterprise of a Contracting State carries on business in the other Contracting State through a permanent establishment situated therein, there shall in each Contracting State be attributed to that permanent establishment the business profits which it might be expected to make if it were a distinct and independent enterprise engaged in the same or similar activities under the same or similar conditions.

U.S. Model Double Taxation Treaty, art. 7(2) (1981), *reprinted in Model Income Tax Treaties* (Kees van Raad ed., 1983); *cf.* Convention Between the United States and the United Kingdom for Avoidance of Double Taxation, art. 7(2), Dec. 31, 1975, U.S.-U.K., 31 U.S.T. 5670, 5675 (U.S.-U.K. Treaty).[14]

How, then, can the U.S. tax permanent establishments under formulary methods, as it does under 26 U.S.C. §§ 863(b) and 882? Three observations can be made in response. First, within the arm's length context established by Article 7(2), the treaty does not forbid the use of all formulary apportionment; it merely mandates the attribution to the branch of the same income that

[13] The following discussion of treaties is based on the analysis contained in Kauder, *The Unspecific Federal Tax Policy of Arm's Length*, 60 Tax Notes 1147.

[14] As discussed by respondent, these provisions govern only the taxing methodology of the federal government and have no applicability to the States. *See* Resp. Br. Barc. 16.

would have been attributed to it under AL/SA. Contrary to Barclays' assertions, it is quite possible for AL/SA and worldwide formulary apportionment to reach the same result—indeed, WWCR is intended to capture those synergies of a unitary business that would have been taken into account by a valid arm's length calculation. Two related businesses, if they were truly dealing with each other at arm's length, would take the synergies that result from their being part of a unitary enterprise into account in allocating the profit of the enterprise between them. Thus, if formulary methods reach the same or similar results as AL/SA in taxing the branch, this would be acceptable under Article 7(2).

Second, Article 7(3) of the U.S. Model Treaty, to which Article 7(2) is subject, expressly requires a "reasonable allocation" of expenses to the branch based on the expenses of the enterprise as a whole. U.S. Model Treaty, art. 7(3); U.S.-U.K. Treaty, art. 7(3), 31 U.S.T. at 5675-76. Thus, the formulary methods of allocating expenses under 26 C.F.R. § 1.882-5 are fully compatible with the U.S. treaty obligations, as the IRS has repeatedly stated. *See* Rev. Rul. 89-115, 1989-2 C.B. 130 (interpreting art. 7(3) of the U.S.-U.K. Treaty); Rev. Rul. 78-423, 1978-2 C.B. 194 (interpreting similar provision in U.S.-Japan Treaty); *see also* Rev. Rul. 85-7, 1985-1 C.B. 188 (same under 26 C.F.R.§ 1.882-5).

Finally, as noted above, formulary apportionment of branch income has been the established practice of the United States since 1922. It is well understood that such an established practice may continue under the AL/SA language of Article 7(2). Indeed, because formulary methods are commonly used by countries that are parties to treaties that require some form of AL/SA, the new OECD model treaty expressly provides:

> Insofar as it has been customary in a Contracting State to determine the profits to be attributed to a permanent establishment on the basis of an apportionment of the total profits of the enterprise to its various parts, nothing in paragraph 2 shall pre-

clude that Contracting State from determining the profits to be taxed by such an apportionment as may be customary; the method of apportionment adopted shall, however, be such that the result shall be in accordance with the principles contained in this Article.

OECD Model (Income and Capital) Tax Treaty, Sept. 1, 1992, art. 7(4).[15] Thus, the United States can continue to tax branches of foreign corporations, such as BBI, based on formulary methods, without violating its treaty obligations.

Let us next look at the treaty rule regarding U.S. subsidiaries of foreign corporations, such as Barcal. Article 9(1) of the U.S.-U.K. treaty provides that "[w]here an enterprise of a Contracting State is related to another enterprise" and the relations between the two depart from arm's length, an adjustment to achieve arm's length conditions "may" be made, and in that case, the other state "shall make such adjustment as may be appropriate" to prevent double taxation resulting from the adjustment. U.S.-U.K. Treaty Art. 9(1) and 9(2), 31 U.S.T. at 5677; *cf.* U.S. Model Treaty Art. 9(1) and 9(2).

Louis M. Kauder suggests that Article 9(1) does not, by its terms, require the United States to do anything regarding the taxation of domestic corporations controlled by foreign parents. Kauder, *The Unspecific Federal Tax Policy of Arm's Length*, 60 Tax Notes at 1149-50. The

[15] For further evidence of the use of formulary in conjunction with arm's length by OECD member nations, *see* Treasury and IRS Report, Appendix E (Report of Agreed Discussions Between the Tax Administrations of France, Germany, the United Kingdom, and the United States) ¶ 3.5, BNA Special Supplement 2, Report No. 70 at S-41 ("In some industries and in some circumstances the use of a formula might be appropriate assuming that the formula attempted to approximate an arm's length result. One [such] area would be global trading . . . ."); *id.*, ¶ 3.6 ("Each one of us has expressed varying levels of support for using carefully tailored formulae in specific situations. The United States sees considerable advantages in this approach in particular cases. Germany and the United Kingdom have agreed to consider the use of such formulae in those cases.").

Senate Foreign Relations Committee, in its report on the Third Protocol of the US/UK Treaty, viewed Article 9(1) as "recogniz[ing] the right of each country to make an allocation of income in the case of transactions between related persons, if an allocation is necessary to reflect the conditions and arrangements which would have been made between unrelated persons." S. Exec. Rep. 5, 96th Cong., 1st Sess. 6 (1979). Thus, Article 9(1) certainly does not forbid the United States from using formulary apportionment, at least within the arm's length context.

In addition, as the *Container* Court pointed out, all of the U.S. treaties generally reserve the right to tax domestic corporations as if the treaty never came into effect. 463 U.S. at 196; *cf.* U.S. Model Treaty, art. 1(3). Thus, the United States could apply any formulary method to domestic subsidiaries of foreign parents, or to United States parents with foreign subsidiaries, without violating any treaty, as long as it is not considered to be taxing the foreign corporations included in the group. *See also* U.S. Model Treaty, art. 9(3) (permitting apportionment under language similar to 26 U.S.C. § 482).

Finally, the U.S.-U.K. treaty contains one unique provision not found in any other United States treaty—the notorious Article 9(4), 31 U.S.T. at 5677, which is the subject of much of the debate in this case. While the Church reservation prevented Article 9(4) from ever applying to California, *see* Resp. Br. Barc. 20-21, it does apply to the federal government, and prevents it from taking into acount the income of a related foreign enterprise in determining the tax liability of its domestic subsidiary. The inclusion of this Article makes it clear that Article 9(1), standing alone, does not prevent the U.S. from using formulary methods. Nor does Article 9(4) prevent the application of WWCR to U.K. subsidiaries of U.S. corporations, which are explicitly excluded from its scope. But even in the case of U.S. subsidiaries of U.K. corporations, the Senate Foreign Relations Committee report on Article 9(4) states that:

> The limitation in Article 9(4) applies only to cases where an allocation is made without regard to any application of the arm's-length standard. Of course, both countries may apply apportionment formulas, including formulas that take into account attributes of related entities, as a method of achieving an arm's-length price for a transaction between related entities. Moreover, apportionment formulas may be used as a method of apportioning income of related entities to the extent that it is established that they are not dealing on an arm's-length basis.

S. Exec. Rep. 5, 96th Cong., 1st Sess. 6 (1979).

Thus, even Article 9(4) does not prevent the federal government from using formulary methods, as long as they reach arm's length results, or it can be established that the related parties were not dealing at arm's length (as will frequently be the case).[16]

In sum, the "one voice" that petitioners contend California must adhere to employs formulary methods akin to California's ubiquitously in its international tax rules, in conjunction with AL/SA. This action by the federal government (and any further federal action along the same lines) does not violate any treaty obligations. And the international pressure on California, compared to the lack of foreign governmental protestations against the federal government, is a reflection of the relative political power of the United States and California, not of the merits of the issue.

[16] It has been reported that Barclays' own "advance pricing agreement" (APA) with the IRS and the U.K. taxing authorities, relating to a significant portion of its business, is based on taxing "the company's international affairs as one global business" and allocating the profits among jurisdictions based on an undisclosed "formulary methodology." *See IRS Grants Two APAs In Derivative Products Area*, Tax Notes Today, 92 TNT 96-1 (May 6, 1992) (discussing APAs for Barclays and Sumitomo). *See also* U.S. Treasury and IRS, *Joint Statement of Policy and Action Plan on International Tax Compliance* (Dec. 17, 1993), *reprinted in* BNA Daily Tax Report (Dec. 20, 1993), at L-2 (in negotiating APAs, the IRS "has made every effort to agree with the taxpayer on an appropriate methodology, and has applied, in appropriate cases, the methods specified in section 482, variations on those methods, and other methods, such as formulary apportionment").

This report suggests that Barclays acknowledges that formulary methods are appropriate for taxing its worldwide unitary business.

C. California's Formulary Method Does Not Pose More Risk Of Multiple Taxation Than The Arm's Length Method As Applied By The Federal Government

California's use of WWCR also satisfies the remaining prong of the foreign Commerce Clause test—it does not create a heightened risk of international multiple taxation. *See Japan Line*, 441 U.S. at 446-48; *Container*, 463 U.S. at 185. Colgate does not even contest this point, and Barclays' multiple taxation argument is inconsistent both with this Court's precedents and with subsequent developments in the arena of international taxation.

In *Container*, this Court addressed the multiple taxation prong of the foreign Commerce Clause test as applied to WWCR and held that WWCR does not violate this test because arm's length as applied by the federal government, may also lead to double taxation:

> A serious problem, however, is that even though most nations have adopted the 'arm's-length' approach in its general outlines, the precise rules under which they reallocate income among affiliated corporations often differ substantially, and whenever that difference exists, the possibility of double taxation also exists. Thus, even if California were to adopt some version of the 'arm's-length approach,' it could not eliminate the risk of double taxation of corporations subject to its franchise tax, and might in some cases end up subjecting those corporations to more serious double taxation than would occur under formula apportionment.

463 U.S. at 191 (footnotes omitted).

Developments since 1983, when *Container* was decided, have dramatically demonstrated the correctness of

these observations. The potential for double taxation under AL/SA results from the basic theoretical flaw of AL/SA—the fact that it does not provide a uniform or consistent way of making allocations where comparables are not available. *See* discussion at pages 8-12, *supra*. International double taxation is the likely outcome of AL/SA because one cannot expect foreign taxing authorities to respect allocations which the U.S. courts admit are based on a "best estimate" slicing of the shadow, or on economically inappropriate "comparables."

That multiple taxation is as likely under AL/SA (as applied by the federal government) as under WWCR is indicated by the reactions to the temporary regulations of foreign interested parties, many of whom are *amici* in this case in support of petitioners. They have vigorously objected to the most recent federal AL/SA plus formulary approach based on their contention that it will lead to international double taxation, and that the temporary regulations do not comport with the arm's length standard. Thus, the International Chamber of Commerce has stated unequivocally:

> We object to this new formulation both on general grounds, in view of the likely damaging consequences for international trade and investment . . . and, more specifically, because within the temporary regulations it is evidently designed to confer arm's length validity on a method—the comparable profits method—which in fact does not accord with the arm's length principle.

Letter of International Chamber of Commerce of 4/22/93, ¶ 11, *reprinted in International Chamber of Commerce Attacks New Transfer Pricing Regs.*, Tax Notes Today, 93 TNT 113-24 (May 27, 1993). The International Chamber of Commerce went on to assert that the federal government's methodology "is contrary to the arm's length principle and will inevitably lead to double taxation. *Id.* at ¶ 21.[17]

[17] The Korean Ministry of Finance has made the same point by complaining that "the revised regulations are still not fully consistent with the internationally accepted arm's length standard." Letter of Rah-Yong Uhm of 8/9/93, Director General for Tax Affairs, Ministry of Finance, Republic of Korea, *reprinted in Korean Finance Ministry Comments on Transfer Pricing Regs.*, Tax Notes Today, 93 TNT 181-49 (Aug. 31, 1993). The Representative of German Industry and Trade has likewise stated that "[w]e continue to have fundamental, grave objections to the temporary intercompany transfer pricing regulations" on the grounds that they lead to incorrect results and "contradict[] the Arm's Length Standard." Letter of Christof S. Klitz of 7/19/93, *reprinted in German Industry Rep Takes Aim At Proposed Regs.*, Tax Notes Today, 93 TNT 163-64 (Aug. 5, 1993). Keidanren, the Japan Federation of Economic Organizations, asserts that the principal innovation of the temporary regulations "is not in accordance with the international rule of transfer pricing taxation . . . . [which] places great emphasis on an arm's length pricing system among entities." Letter of Tsunekazu Sakano of 7/13/93, ¶ 1, *reprinted in Keidanren Urges IRS to Take Another Look at Proposed Regs.*, Tax Notes Today, 93 TNT 158-24 (July 29, 1993).

It is thus clear that AL/SA, as applied by the federal government, is at least as likely to lead to international double taxation as WWCR. As the Court has already held, "it would be perverse, simply for the sake of avoiding double taxation, to require California to give up one allocation method that sometimes results in double taxation in favor of another allocation method that also sometimes results in double taxation." *Container*, 463 U.S. at 193 (citation omitted).

II. CALIFORNIA'S FORMULARY METHOD DOES NOT VIOLATE THE DUE PROCESS CLAUSE, AS IT IMPOSES NO HEAVIER BURDEN ON MULTINATIONAL CORPORATIONS THAN IS IMPOSED UNDER CURRENT FEDERAL LAW

Barclays' due process argument ignores the extensive requirements imposed on foreign-based multinationals under federal law, which have not been challenged on due process grounds. While California only needs worldwide payroll, asset, and sales data, and net worldwide income, the federal government needs a much broader range of information on the business of the foreign-based enterprise to implement AL/SA. In 1989 and

1990, Congress amended the Internal Revenue Code to authorize the Treasury to prescribe broad record keeping requirements for corporations that are 25% foreign owned, such as Barcal, and for foreign corporations engaged in a U.S. business, such as BBI, in both cases with penalties for noncompliance. *See* Pub. L. No. 101-239, § 7403, 103 Stat. 2358 (1989) (amending 26 U.S.C. § 6038A); Pub. L. No. 101-508, § 11315, 104 Stat. 1388-456 (1990) (adding 26 U.S.C. § 6038C).[18]

The following is just an illustrative list of the records required to be kept by foreign-owned corporations and foreign corporations under regulations promulgated to implement these sections in 1991: original entry books and transaction records relevant to transactions with the U.S. subsidiary; records from which "material profit and loss statements" can be constructed, including an explanation of any differences with United States generally accepted accounting principles (GAAP); "all documents relevant to establishing the appropriate price or rate for transactions" between the U.S. subsidiary and "any foreign related party"; all relevant "[f]oreign country and third party filings"; "[o]wnership and capital structure records"; and "[r]ecords of loans, services, and other nonsales transactions." 26 CFR § 1.6038A-3(c)(2).[19] The foreign party must deliver those documents to the Internal Revenue Service, or give the Service access to the records in the U.S., within 60 days of a request, and provide a translation of the records within 30 days of an IRS request. 26 CFR § 1.6038A-3(f). A substantial portion of the records must be created if they do not exist. 26 CFR § 1.6038A-3(c)(1).

Compared to these broad requirements, the burden imposed by California's rules, subject as they are to a "rea-

[18] Until 1989, it was difficult for the IRS to obtain the required information from foreign entities. *See, e.g., U.S. v. Toyota Motor Corp.*, 561 F.Supp. 354 (C.D. Cal. 1983); *U.S. v. Toyota Motor Corp.*, 569 F.Supp. 1158 (C.D. Cal. 1983).

[19] *See also* the elaborate rules for determining what is a "material profit and loss statement" under 26 CFR § 1.6038A-3(c)(3)-(6).

sonably approximate" standard, pales to insignificance. Of course, "while Congress has plenary power to regulate commerce . . . it does not similarly have the power to authorize violations of the Due Process Clause." *Quill Corp. v. North Dakota*, 112 S. Ct. 1904, 1909 (1992). If this Court strikes down California's WWCR as unconstitutional on due process grounds, it jeopardizes the constitutionality of significant federal transfer pricing enforcement powers as well, which Congress has judged necessary to ensure that foreign-owned U.S. corporations pay their fair share of taxes.

The same analysis applies with even greater force to Barclays' argument that California's rules are too vague and arbitrary, despite being subject to court supervision. *See* Pet. Br. Barc. 47 (citing Cal. Admin. Code Tit. 18 § 25137-6).[20] It has been commonplace in litigation under 26 U.S.C. § 482 for courts to complain that in the absence of specific standards to guide them when there are no comparables, and given the extremely broad language of the statute, the IRS and the courts are required to reach decisions that are essentially arbitrary.[21] Perhaps the classic statement comes from a case decided in favor of the federal government, where the court's task was likened to "making bricks without straw." *Du Pont*, 608 F.2d at 461 (citation omitted) (Nichols, J. concurring). Judge Nichols went on to elaborate:

> [T]he Congressional request to write regulations to govern these § 482 reallocations is one sentence long: 'it is believed that the Treasury should explore the possibility of developing and promulgating regulations under this authority [§ 482] which would provide additional guidelines and formulas for the allocation of income and deductions in cases involving foreign income.' Clearly the result of our decision is that

[20] It is worth noting that California's Regulation 25137-6, the subject of Barclays' attack (*see* Pet. Br. Barc. 47-49), is derived from IRS regulations. *See* 26 C.F.R. § 1.964-1 (1992). If § 25137-6 is invalid, the federal regulation is similarly suspect.

[21] *See* the cases cited above in Part I.A; *see also* J.A. 829 (expert testimony of David R. Tillinghast).

> this has not been done . . . and it remains in the almost if not wholly unreviewable discretion of the Treasury, as it was when the suggestion was made.

Id. at 462 (internal citation omitted).

This lack of guidelines persisted until the temporary regulations were issued in 1993. However, the federal government's discretion under 26 U.S.C. § 482 has never been attacked on due process grounds, because (as in California) the courts were available to ensure that it was not applied in an arbitrary and capricious fashion, and in fact the courts have repeatedly struck down IRS assessments under 26 U.S.C. § 482.[22] The same analysis applies to California's analogous provisions. If this Court strikes down California's WWCR on due process grounds, it would cast a heavy shadow of doubt on the hundreds of cases that are currently pending under the federal law that preceded the issuance of the temporary regulations in 1993.

CONCLUSION

The judgments below should be affirmed.

Respectfully submitted,

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January 19, 1994

[22] *See, e.g.*, cases cited above in Part I.A. *Cf. Panhandle Oil Co. v. Mississippi ex rel. Knox*, 277 U.S. 218, 223 (1928) (Holmes, J., dissenting) ("The power to tax is not the power to destroy while this Court sits."), *overruled by Alabama v. King & Boozer*, 314 U.S. 1 (1941).

(41) (21)

Nos. 92-1384, 92-1839

In The

Supreme Court of the United States

October Term, 1993

BARCLAYS BANK PLC,

Petitioner,

v.

FRANCHISE TAX BOARD,

Respondent.

COLGATE-PALMOLIVE COMPANY,

Petitioner,

v.

FRANCHISE TAX BOARD,

Respondent.

On Writs Of Certiorari To The Court Of Appeal Of The State of California In And For The Third Appellate District

MOTION FOR LEAVE TO FILE BRIEF AMICUS CURIAE AND BRIEF OF CALIFORNIA LEGISLATURE AS AMICUS CURIAE IN SUPPORT OF RESPONDENT

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MOTION FOR LEAVE TO FILE BRIEF AMICUS CURIAE AND BRIEF AMICUS CURIAE

The California Legislature hereby respectfully moves for leave to file the attached brief amicus curiae in these cases. The consents of the attorneys for the respondent have been obtained. The consents of the attorneys for the petitioners were requested but refused.

The interest of the California Legislature in these cases arises from the fact that the California Legislature holds the express power to enact legislation to impose taxes upon corporations in the State of California pursuant to the California Constitution. Any limitation on the use of worldwide combined reporting to determine taxable income attributable to California would have the effect of circumscribing that power of the California Legislature. The brief of amicus curiae will set forth arguments relating to (1) the impact that the issues raised before the Court have upon the sovereign taxing power of California and (2) the efforts of the California Legislature to exercise the State's power to tax, with respect to corporations that are doing business in California and are engaged in a unitary business with foreign affiliated corporations, with due regard to California's budgetary constraints, with fairness to all affected taxpayers, and in deference to federal governmental concerns regarding the state's use of worldwide combined reporting.

The California Legislature believes that it can provide a different perspective to the Court in its examination of the issues presented, and that its arguments, if

accepted, would be dispositive of many of the issues presented in these cases.

Respectfully submitted,

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BRIEF OF CALIFORNIA LEGISLATURE AS AMICUS CURIAE IN SUPPORT OF RESPONDENT

The California Legislature submits this brief, as amicus curiae, pursuant to Rule 37 of the Rules of the Supreme Court of the United States, in support of respondent.

INTEREST OF AMICUS CURIAE

The California Legislature holds the express power to impose taxes upon corporations in the State of California pursuant to the California Constitution. Any limitation on the use of worldwide combined reporting to determine taxable income attributable to California would have the effect of circumscribing that power of the California Legislature. This brief will demonstrate (1) the impact that the issues raised before the court have upon the sovereign taxing power of the California Legislature and (2) the efforts of the California Legislature to exercise this power, with respect to corporations that are doing business in California and are engaged in a unitary business with foreign affiliated corporations, with due regard to California's budgetary constraints, with fairness to all affected taxpayers, and in deference to federal governmental concerns regarding the state's use of worldwide combined reporting.

SUMMARY OF ARGUMENT

The Tenth Amendment to the United States Constitution guards against undue federal interference with certain core state functions. No function of state government is more essential to its sovereignty than the administration and collection of taxes. California has enacted a fairly apportioned, nondiscriminatory corporate franchise tax that is applied equally to all unitary businesses. The apportionment formula used to calculate the state tax results in a determination of the amount of income that is fairly attributable to the business activities in California of a unitary business, regardless of where the balance of the unitary business may be located.

The imposition of this fairly apportioned, nondiscriminatory tax by California on corporations doing business in California does not impair federal rights to regulate foreign commerce or impact upon the federal government's ability to speak with "one voice" with regard to foreign affairs. The Congress of the United States alone holds the power to regulate commerce with foreign nations. The President of the United States holds the power to make treaties with the advice and consent of the United States Senate. However, the Congress has deliberately and repeatedly refused to prohibit the use by the States of worldwide combined reporting as a means of determining the tax liability of unitary businesses with both foreign and domestic commercial activities. In addition, no treaty has been made by the President that would prohibit the use of worldwide combined reporting in connection with the state taxation of those unitary businesses.

Finally, the California Legislature has consistently identified the concerns of the federal government and the domestic and international business communities with regard to California's use of worldwide combined reporting and has revised and recast California's corporate franchise tax law in a conscientious effort to address those concerns.

ARGUMENT

I. THE POWER TO TAX IS AN INHERENT RIGHT OF THE STATE OF CALIFORNIA AND ITS EXERCISE MAY NOT BE LIMITED BY MERE IMPLICATION; NO FEDERAL CONSTITUTIONAL PROVISION PROHIBITS THE USE OF WORLDWIDE COMBINED REPORTING, THUS, THE EXERCISE HERE OF THE SOVEREIGN RIGHT OF CALIFORNIA TO TAX IS PROPER

A. The Tenth Amendment Ensures California's Sovereignty, Thereby Creating a Dual System of Sovereignty Between California and the Federal Government Under Which Neither Entity May Impair the Sovereignty of the Other

The Tenth Amendment to the United States Constitution provides that "[t]he powers not delegated to the United States by the Constitution, nor prohibited by it to the states, are reserved to the states respectively, or to the people." The thrust of this constitutional provision is that the States are not mere political subdivisions of the United States. Instead, the several States retain a residuary and inviolable sovereignty. *New York v. United States*, 505 U.S. ___, 120 L. Ed. 2d 120, 158 (1992). In recognition

of this sovereignty, the Constitution confers upon Congress the power to regulate individuals, not States. Consequently, although Congress is granted the power to regulate commerce, it lacks the power to directly compel the States to regulate commerce. *Id.*, 120 L. Ed. 2d at p. 144.

As this Court recently recognized, "[t]he States retain substantial sovereign authority under our constitutional system." *Gregory v. Ashcroft*, 501 U.S. ___, 115 L. Ed. 2d 410, 422 (1991). Although Congress may legislate in areas traditionally regulated by the states pursuant to the Supremacy Clause, Congress does not exercise that power lightly. "[O]ur Constitution establishes a system of dual sovereignty between the States and the Federal Government," *Id.* (115 L. Ed. 2d 410, 421), for it is "founded upon the total or partial incorporation of a number of distinct sovereignties." Alexander Hamilton, *The Federalist No. 82*, p. 458 (I. Kramnick ed., 1987). "[T]he Court's consistent understanding" is that " '[t]he States unquestionably do retai[n] a significant measure of sovereign authority . . . to the extent that the Constitution has not divested them of their original powers and transferred those powers to the Federal Government.' " *New York v. United States*, 505 U.S. ___, 120 L. Ed. 2d 120, 137 (1992), quoting *Garcia v. San Antonio Metro. Transit Auth.*, 469 U.S. 528, 549, 83 L. Ed. 2d 1016, 1033 (1985). Almost 70 years ago, this Court discussed the tension between state and federal taxing powers as follows:

> "[N]either government may destroy the other nor curtail in any substantial manner the exercise of its powers. Hence, the limitation upon the taxing power of each, so far as it affects the other, must receive a practical construction which permits both to function with the minimum of interference each with the other; and that limitation cannot be so varied or extended as seriously to impair either the taxing power of the government imposing the tax (*South Carolina v. United States*, 199 U. S. 437, 461, 50 L. ed. 261, 269, 26 Sup. Ct. Rep. 110, 4 Ann. Cas. 737; *Flint v. Stone Tracy Co.* 220 U. S. 172, 55 L. ed. 421, 31 Sup. Ct. Rep. 342, Ann. Cas. 1912B, 1312) or the appropriate exercise of the functions of the government affected by it (*Union P. R. Co. v. Peniston*, 18 Wall. 31, 21 L. ed. 791)." *Metcalf & Eddy v. Mitchell*, 269 U.S. 514, 523, 70 L. Ed. 384, 392 (1926).

In *EEOC v. Wyoming*, 460 U.S. 226, 75 L. Ed. 2d 18 (1983), this Court (in both its majority and dissenting opinions) reaffirmed the importance and vitality of constitutional principles of federalism in analyzing Congress's exercise of its powers under the Commerce Clause. The majority in that case, speaking through Justice Brennan, concluded that the principles of federalism embodied in the Tenth Amendment did not bar application of the Age Discrimination in Employment Act of 1967 to a State's game wardens. The Court nevertheless emphasized that the Tenth Amendment guards against "undue federal interference in certain core state functions" and ensures the "unique benefits of a federal system in which States enjoy a 'separate and independent existence.' " *Id.*, 460 U.S. at p. 236, quoting, in part, *Lane County v. Oregon*, 74 U.S. (7 Wall.) 71, 76, 19 L. Ed. 101, 104 (1869).

B. The Power to Tax is at the Core of California's Sovereignty and May Not be Interfered With by the Federal Government in the Absence of a Direct and Substantial Interference With a Federal Power

The power to tax is essential to the very existence of state government and may be exercised to the utmost

extent, limited only by the structure of the government itself. *M'Culloch v. The State of Maryland et al.*, 17 U.S. (4 Wheat.) 316, 428, 4 L. Ed. 579, 607 (1819). The power to tax is not confined to the people or property of a State, but may be exercised with respect to every object brought within a State's jurisdiction. *Id.*, 17 U.S. (4 Wheat.) at p. 429; *Harvester Co. v. Dept. of Taxation*, 322 U.S. 435, 444-45, 88 L. Ed. 1373, 1381 (1944).

Thus, no function of state government goes more to the core of its sovereignty than the power to tax. See, e.g., *Bode v. Barrett*, 344 U.S. 583, 585, 97 L. Ed. 567, 571 (1953). Federal interference with that function, whether by the courts or Congress, has limitless potential to disrupt the operation of state governments.[1] Accordingly, this Court has long recognized "the important and sensitive nature of state tax systems and the need for federal-court restraint when deciding cases that affect such systems." *Fair Assessment in Real Estate Assn. v. McNary*, 454 U.S.

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[1] If this Court retroactively prohibits the use of worldwide combined reporting, as urged by petitioners, it is estimated that the State of California will lose $4.0 billion in revenue. That amount represents disputed taxes collected or collectable over the past three decades. However, if the disputed taxes are refunded in a single year as a result of a decision adverse to respondent, they would represent approximately 8 percent of the State's 1993-94 annual state budget of $52.1 billion. Ch. 55, Cal. Stats. 1993. Since 1977, the last tax year (income year) at issue here, the State of California has experienced deficits in 12 of the succeeding 16 years. California Legislative Analyst's Office *CAL Facts* (May 1993), p. 29 [Appendix A]. As a result of these shortfalls in revenue, the loss of 8 percent of the state budget would seriously threaten California's fiscal stability and would force further budget reductions in essential public services.

100, 102, 70 L. Ed. 2d 271, 274 (1981); see also *United States v. California*, 507 U.S. ___, 123 L. Ed. 2d 528 (1993); *Great Lakes Co. v. Huffman*, 319 U.S. 293, 87 L. Ed. 1407 (1943); *Mathews v. Rodgers*, 284 U.S. 521, 76 L. Ed. 447 (1932); *First Natl. Bank v. Weld County*, 264 U.S. 450, 68 L. Ed. 784 (1924). Over a century ago in *Dows v. City of Chicago*, 78 U.S. (11 Wall.) 108, 20 L. Ed. 65 (1871), this Court was confronted with a question of whether a State should be enjoined from collection of a tax even if it is conceded that the tax is illegal. In exercising judicial restraint by denying equitable relief, this Court stated:

> "It is upon taxation that the several States chiefly rely to obtain the means to carry on their respective governments, and it is of the utmost importance to all of them that the modes adopted to enforce the taxes levied should be interfered with as little as possible. Any delay in proceedings of the officers, upon whom the duty is devolved of collecting taxes, may derange the operations of government, and thereby cause serious detriment to the public." *Dows v. City of Chicago*, 78 U.S. (11 Wall.) 108, 110, 20 L. Ed. 65, 66 (1871).

A State's power to tax is not derived from the Constitution of the United States, but exists independently therefrom. *Railroad Company v. Peniston*, 85 U.S. (18 Wall.) 5, 29, 21 L. Ed. 787, 791 (1873). The sole constitutional provision restricting the State's power to impose taxes is the general prohibition upon the laying of imposts or duties on imports or exports. U.S. Const., Art. I, Sec. 10; *Railroad Company v. Peniston*, supra, 85 U.S. (18 Wall.) at p. 29. Neither petitioner claims that this constitutional provision is implicated here.

Although a State may not levy taxes that directly hinder the exercise of any power that belongs to the federal government, a state tax that only remotely affects the efficient exercise of a federal power is, for that reason alone, not prohibited by the Constitution. *Id.*, 85 U.S. (18 Wall.) at p. 30. Thus, unless it is clearly shown that there is some particular, direct, and substantial, and not merely an incidental or gratuitous, interference with a federal right, a State, is free to exercise its taxing power. *Shannon v. Streckfus Steamers*, 279 Ky. 649, ___, 131 S.W. 2d 833, 838 (1939). Moreover, a State's power to tax may not lightly be stricken down on the basis of mere implication. *Great Lakes Dredge & Dock Co. v. Charlet*, 134 F. 2d 213, 216 (5th Cir., 1943), affd. *Great Lakes Co. v. Huffman*, 319 U.S. 293, 87 L. Ed. 1407 (1943).

Section 27 of Article XIII of the California Constitution expressly permits the California Legislature to "tax corporations, including State and national banks, and their franchises by any method not prohibited by this Constitution or the Constitution or laws of the United States." Accordingly, in the absence of a direct and substantial interference with a federal power, the State's power to tax cannot be circumscribed by the federal government.

Petitioner Barclays Bank PLC ("Barclays") asserts that there is international objection to the use of worldwide combined reporting. Brief for Petitioner Barclays, at pp. 6-7. However, the national policy established by the Congress and the federal Executive clearly permitted the use of worldwide combined reporting during the tax years (income years) in dispute. See Argument III B, infra, at pp. 19-24. Thus, the assertion of Barclays does

not establish a direct and substantial interference with any federal power and, consequently, the power of the California Legislature to impose taxes in the manner at issue here may not be limited.

C. If Congress Perceives that California's Exercise of Its Power to Tax is Impinging upon Congressional Power to Regulate Foreign Commerce, then Congress Is the Proper Body to Limit California's Power to Tax

Rather than this Court imposing judicially constructed restraints on the power of States to impose taxes, Congress is in the best position to act to restrict or curtail state powers to tax based on any perceived intrusion into Congress' power with respect to foreign commerce. However, in the period of a decade and a half since Barclays filed its return for the tax year at issue, Congress has deliberately chosen not to limit the State's power to use worldwide combined reporting despite the introduction of various federal legislative proposals to limit that power. See discussion in Argument III A, infra, at pp. 18-19.

II. THE TAX IMPOSED BY CALIFORNIA ON CORPORATIONS THAT DO BUSINESS IN THE STATE, INCLUDING CORPORATIONS WITH FOREIGN AFFILIATES, IS FAIRLY APPORTIONED AND NOT DISCRIMINATORY

Formulary apportionment has been approved for more than a century as a means of fairly dividing a single tax burden among several jurisdictions in which a taxpayer does business. See *State Railroad Tax Cases*, 92 U.S. 575, 23 L. Ed.

663 (1875). The Constitution imposes no single formula on the States. *Container Corp. v. Franchise Tax Bd.*, 463 U.S. 159, 164, 77 L. Ed. 2d 545, 552 (1983). California's three-factor formula of property, payroll, and sales was approved by this Court over a half century ago, *Butler Bros. v. McColgan*, 315 U.S. 501, 86 L. Ed. 991 (1942), and has become a benchmark against which other apportionment formulas are measured. *Trinova Corp. v. Michigan Dept. of Treasury*, 498 U.S. 358, 380-381, 112 L. Ed. 2d 884, 909 (1991), citing *Container Corp. v. Franchise Tax Bd.*, supra, at p. 170; see *Moorman Mfg. Co. v. Bair*, 437 U.S. 267, 284, 57 L. Ed. 2d 197, 210 (Blackmun, J., dissenting) (1978).

Petitioners do not make any claim before this Court that the tax imposed on them using formulary apportionment is not a fairly apportioned tax. Petitioners primarily object to the mechanical means of determining their tax: worldwide combined reporting. Specifically, petitioners assert that multinational corporations are entitled to determine their tax in a manner different from wholly domestic unitary enterprises doing business in California because petitioners are each a part of a unitary business that has a structure that includes a foreign affiliate.

The essence of Barclays' assertions is that it should be treated differently because one of its foreign affiliates is the parent corporation, Brief for Petitioner Barclays, at p. 3. However, a differential means of taxation based on whether a corporation has a foreign or domestic domicile would violate the foreign commerce clause. See *Kraft Foods v. Iowa Dept. of Rev.*, 505 U.S. ___, 120 L. Ed. 2d 59, 67 (1992). Moreover, the exploitation by foreign corporations of intrastate opportunities under the protection and encouragement of local government offers a basis for taxation as unrestricted as that for domestic corporations. *Commonwealth Edison Co. v. Montana*, 453 U.S. 609, 623, 69 L. Ed.

2d 884, 898 (1981). This Court has made clear that the Commerce Clause does not relieve foreign corporations from paying their just share of the state tax burden even though it increases the cost of doing business, because to do so would be to place those corporations in a privileged position. *Id.*, 453 U.S. at pp. 623-624.

Petitioner Colgate-Palmolive Company ("Colgate") makes a similar claim based on the inclusion of its foreign subsidiary corporations, Brief of Petitioner Colgate, at p. 47, even though this Court has previously rejected an identical claim. Specifically, this Court has previously concluded that California's application of the unitary business principle and the three-factor formula to a domestic corporation with overseas subsidiaries was proper and not unconstitutional. *Container Corp. v. Franchise Tax Bd.*, 463 U.S. 159, 184, 77 L. Ed. 2d 545, 565 (1983). More importantly, this Court took note of, and approved, the worldwide combined reporting method used to determine the tax owed by the unitary group in that case. *Id.*, 463 U.S. at pp. 174-175.

Even though Barclays claims that the method of taxation imposes a discriminatory compliance burden, the California Court of Appeal found that the compliance burden was not unconstitutional because California required the same information from all taxpayers. *Barclays Bank Internat. Ltd. v. Franchise Tax Bd.*, 10 Cal. App. 4th 1742, 1753-1756. Under the method employed in California, the amount of tax owed is the same regardless of whether the parent corporation of a group of corporations that operate as a unitary business is located in California, in another State, or in a foreign country. See Cal. Rev. & Tax. Code Sec. 25101. The tax calculation is

neutral in that respect, and clearly nondiscriminatory. The location of the parent corporation is irrelevant to the tax calculation and has no bearing upon what records are required or must be maintained in order for that portion of the unitary business that does business in California to file a tax return or combined report in California. The only information a taxpayer needs with regard to its unitary business is a record of its business income, property, payroll, and sales. Cal. Rev. & Tax. Code Sec. 25128.

Each corporation that does business in California is required to file a tax return. Cal. Rev. & Tax. Code Sec. 25401. In addition, corporations doing business in California that are part of a unitary business are required to file a combined report. Cal. Rev. & Tax. Code Sec. 25101.

The problem inherent in taxing a multinational unitary business is that there is a single worldwide business, and in some fashion a jurisdiction, such as California, must fairly apportion the business income of that unitary business to the jurisdiction in order to determine a tax upon that income. Petitioners do not claim that either of them is other than a part of a unitary business. The existence of a unitary business indicates that there are economies of scale and transfers of value among the affiliated corporations. See *Container Corp. v. Franchise Tax Bd.*, 463 U.S. 159, 166, 77 L. Ed. 2d 545, 554 (1983).

To determine a fair tax, California must determine what portion of business activity is fairly attributable to California. Implicitly, where there is a unitary business there is some single entity that is a part of that business that has a record of the value of the whole business. Under the method employed in California, the tax rate is

applied to that portion of the net income that is attributable to the business in California. The amount of business activity attributable to California is measured by determining the proportion that the property, payroll, and sales in the State of the unitary business bears to the total of the property, payroll, and sales everywhere of the unitary business. Cal. Rev. & Tax. Code Sec. 25128.

Thus, as the calculation is applied to any unitary business that does business within the State of California, the calculation is blind as to where the parent corporation of the group is located.[2] The parent corporation may be located in California, elsewhere in the United States, or in another country. As among the members of the unitary group, it is immaterial who maintains sufficient data to make the calculation of business activity attributable to the State of California, and it is immaterial where that data is maintained. It is sufficient that the tax records of the unitary business are maintained by some member of the group, whether it be a subsidiary located in California, a subsidiary located elsewhere, a parent corporation located in California, or a parent corporation located anywhere in the world.

Moreover, use of the California three-factor formula is well-established, *Butler Bros. v. McColgan*, 315 U.S. 501, 509, 86 L. Ed. 991, 997 (1942), and does not result in a

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[2] In fact, the parent corporation may not even be a part of the unitary business. There may well be examples of unitary groups in which there is no integration between the parent corporation and the unitary business that does business in California. In that instance, the formula would exclude any factors, or value, of the parent corporation from the calculation of the tax.

"novel state tax" that carries a risk of asymmetry in the international tax structure. See *Container Corp. v. Franchise Tax Bd.*, 463 U.S. 159, 194-195, 77 L. Ed. 2d 545, 572 (1983). Although Barclays asserts that automatic asymmetry results, Brief for Petitioner Barclays, at pp. 28-29, that is clearly not the case. Using the three-factor formula as a means of apportioning business income, a foreign multinational that has the same portion of its business activity in California as a domestic multinational will pay the same tax.

Petitioners seek to circumscribe a method of fairly apportioning taxes that has been successfully used by states for over a century. Barclays bases its rationale upon an assertion that the foreign parent corporation within its unitary business objects to the imposition of a fairly apportioned tax upon corporations that do business within the State of California. Brief for Petitioner Barclays at pp. 11-12. The implication of that assertion is that a unitary business that does business in California ought to be accorded special treatment if the unitary business has a parent corporation that is located in a foreign country.[3]

[3] It is clear that domestic subsidiary corporations of a foreign parent corporation are not entitled to any special treatment under a treaty with the national government of the foreign parent. *Sumitomo Shoji America, Inc. v. Avagliano*, 457 U.S. 176, 188-189, 72 L. Ed. 2d 765, 774-775 (1982). The logical corollary to this holding is that in absence of an express treaty provision both foreign and domestic corporations doing business in a jurisdiction within this country should be treated alike. In accordance with this principle, California applies the same formulary apportionment method to all unitary businesses regardless of the place of their incorporation.

The California Legislature believes that its power ought not to be curtailed where it has merely imposed a tax on activity within the borders of the State of California. The imposition of a tax on discrete activity in California of corporations doing business within the state does not, in and of itself, implicate foreign affairs. The controversy arises in this case from the methodology used to measure California activity that takes into consideration worldwide activity in order to derive a measure of activity within California. The mere fact that this controversy may have arisen in an international context because a multinational corporation objects to the particular method that California and other States in this nation use to apportion income to each State does not, by itself, establish that the method impinges on the exclusive federal power concerning the conduct of foreign affairs.

The State of California, acting through its Legislature, has a sovereign right to impose nondiscriminatory, fairly apportioned taxes on corporations doing business within the State's borders. No federal constitutional provision prohibits the use of worldwide combined reporting. Thus, the exercise here of the sovereign right of California to tax is proper. Corporations that engage in business in more than one jurisdiction are not immune from paying a fair state tax. *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274, 277, 51 L. Ed. 2d 326, 330 (1977). Accordingly, the California Legislature should continue to be permitted to impose fairly apportioned and nondiscriminatory taxes on any unitary business that does business in California without regard to where outside of California the affiliated corporations of the unitary business are located.

III. CALIFORNIA'S APPLICATION OF WORLDWIDE COMBINED REPORTING TO PETITIONERS WITH RESPECT TO THE TAX YEARS AT ISSUE DID NOT PREVENT THE FEDERAL GOVERNMENT FROM SPEAKING WITH ONE VOICE WHEN REGULATING RELATIONS WITH FOREIGN GOVERNMENTS; RATHER, THE EFFORTS OF THE CALIFORNIA LEGISLATURE IN ENACTING LAWS RELATING TO WORLDWIDE COMBINED REPORTING HAVE BEEN ENTIRELY CONSISTENT WITH FEDERAL POLICY AND HAVE ADDRESSED SPECIFIC CONCERNS RAISED BY THE FEDERAL GOVERNMENT AND MULTINATIONAL CORPORATIONS

In *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274, 51 L. Ed. 2d 326 (1977), this Court adopted a four-part test to determine whether a state tax is valid against a Commerce Clause challenge: specifically, the tax must be applied to an activity with a substantial nexus with the taxing State; it must be fairly apportioned; it must not discriminate against interstate commerce; and it must be fairly related to the services provided by the State. *Id.*, 430 U.S. at p. 279.

When foreign commerce is at issue, this Court has held that, in addition to the four-part test, the tax must not create a substantial risk of international multiple taxation, and it must not prevent the federal government from speaking with one voice when regulating relations with foreign governments. *Japan Line, Ltd. v. County of Los Angeles*, 441 U.S. 434, 450, 60 L. Ed. 2d 336, 349. This Court has held that a state tax at variance with federal policy will violate the "one voice" standard if it either implicates foreign policy issues which must be left to the

federal government or violates a clear federal directive. *Container Corp. v. Franchise Tax Bd.*, 463 U.S. 159, 194, 77 L. Ed. 2d 545, 571-572 (1983). In that case, this Court decided that if a state tax merely has foreign resonances, but does not implicate foreign affairs, the Court cannot infer, absent some explicit directive from Congress, that treatment of foreign income at the federal level mandates identical treatment by the States. *Id.*, 463 U.S. at p. 571.

Barclays asserts that worldwide combined reporting undeniably implicates foreign policy issues which must be left to the federal government and prevents the nation from speaking with one voice. Brief for Petitioner Barclays, at p. 22. Barclays has previously asserted, both in the Supreme Court of California below and in its Petition for a Writ of Certiorari, that respondent's application of formula apportionment to the unitary business of which it is a part offends the foreign Commerce Clause because it violates a clear federal directive that is embodied in an array of federal Executive communications. *Barclays Bank Internat., Ltd. v. Franchise Tax Bd.*, 2 Cal. 4th 708, 726 (1992); Petition for Writ of Certiorari by Petitioner Barclays, at pp. 17 to 20, incl. Barclays now asserts in its opening brief that the use of a method of state taxation other than the arm's length method frustrates United States policy, and that the use of worldwide combined reporting results in the clearest foreign policy implication, namely, the risk of foreign retaliation. Brief for Petitioner Barclays, at pp. 22, 25. Colgate makes similar assertions. Brief of Petitioner Colgate, at pp. 6, 16, 17, 32 to 36, incl.

Petitioners' assertions ignore, among other things, that Congress has deliberately and repeatedly refused to enact a prohibition on the use of worldwide combined reporting by the States, and that the California Legislature has undertaken conscientious efforts to respond to the concerns of both the federal government and multinational corporations in connection with the State's modification of worldwide combined reporting. Moreover, petitioners' assertions are not consistent with the constitutional grant of authority provided by the Commerce Clause and misconstrue what the federal policy was during the tax years at issue in these cases.

A. Congress has Deliberately and Repeatedly Refused to Prohibit the Use of Worldwide Combined Reporting by the States

In 1978, the United States Senate specifically rejected article 9(4), as originally negotiated, in a bilateral tax treaty with the United Kingdom that would have disallowed worldwide combined reporting by the States. See Remarks of Senators Cranston, Javits, and Pell, 124 Cong. Rec. 18400, 19076 (1978). Significantly, this treaty was ratified by the United States Senate only after that provision was removed. *Ibid.* These facts, along with Congressional rejections of a number of federal legislative proposals with similar prohibitory provisions, were best summarized by the Supreme Court of California below, as follows:

> "The Senate's action with respect to article 9(4) is only the most explicit example of a persistent congressional refusal to enact curbs on the states' use of worldwide formula apportionment reaching back well before 1977, the tax year at issue in this case. The parties agreed in a pretrial stipulation that 'various proposed Legislative bills have been introduced in the United States Congress that would, among other things, affect the states' use of worldwide combined reporting.' The stipulation identifies twenty such House and Senate bills spanning twenty years. These range from House Resolution No. 11798 introduced in the House in 1965 (an ambitious 'Interstate Taxation Act' that would have required the states to adopt a two-factor apportionment formula in taxing unitary groups) to 1985 legislation sponsored by the Treasury Department that would have limited state use of worldwide formula apportionment to members of foreign-based corporate groups actually doing business in the United States, that is, so-called 'water's edge' legislation. (See *post*, pp. 739-740.) None of these measures was enacted into law by Congress." *Barclays Bank Internat., Ltd. v. Franchise Tax Bd.*, 2 Cal. 4th 708, 736 (1992).

B. The California Legislature has Responded Appropriately to the Concerns of both the Federal Government and Multinational Corporations

In 1983, shortly after this Court's decision in *Container Corp. v. Franchise Tax Bd.*, 463 U.S. 159, 77 L. Ed. 2d 545 (1983), the federal government announced plans to establish a working group composed of representatives of the federal government, state governments, and the business community to produce recommendations "that will

be conducive to harmonious international economic relations, while also respecting the fiscal rights and privileges of the individual states." Chairman's Report and Supplemental Views, Final Report of the Worldwide Unitary Taxation Working Group (Aug. 1984), Office of the Secretary, Department of the Treasury.

The final report of the working group, released in 1984, made recommendations for the states to mitigate the international effects of formula apportionment, including limiting its use to the "water's edge" (whereby certain affiliated entities of a unitary group are excluded from the unitary tax base). *Id.*, at p. iii.

The report stated that if states enact legislation based on the three principles agreed upon by the Working Group ((1) water's edge unitary combination for both U.S. and foreign based companies, (2) increased federal administrative assistance and cooperation with the States to promote full taxpayer disclosure and accountability, and (3) competitive balance for U.S. multinationals, foreign multinationals, and purely domestic businesses), the United States will be able to speak with one voice in dealing with its foreign trading partners. *Ibid.*

In response to the recommendations of the Chairman's Report, the California Legislature in 1986 enacted Senate Bill No. 85 (Ch. 660, Cal. Stats. 1986), which authorized a water's edge election for tax years beginning on or after January 1, 1988.[4] Specifically, S.B. 85 allowed a

[4] Thus, the assertion by one of amicus curiae supporting petitioners, that California currently uses "forced" worldwide combined reporting, is flatly wrong. See Brief of the Committee

qualified taxpayer, as defined, whose income is subject to the California franchise tax to determine its income derived from or attributable to sources within California pursuant to a water's edge election upon the payment of a specified election fee. Under this election, only the income and apportionment factors of certain affiliated entities (generally those located within the boundaries of the United States) would be included in the unitary tax base.

As the result, in part, of California's enactment of S.B. 85, the Honorable J. Roger Mentz, Assistant Secretary (Tax Policy) of the Department of the Treasury stated as follows:

> "I am pleased to report that, since the introduction of the legislation, Idaho, New Hampshire, Utah and, on September 5, California, have enacted "water's edge" legislation. The Administration applauds these states' actions. *These state legislative developments go a long way toward resolving the difficult unitary tax issue. Moreover, they illustrate the successful operation of the Federal system.* These and the other states that have moved away from the worldwide unitary tax system in recent years recognize that their interest, and the national interest, lies in a single, coherent approach to taxing international income that minimizes tax-related impediments to international flows of investment capital.
>
> "We have not, however, reached the end of the road with respect to this issue. Though the

on State Taxation as Amicus Curiae in Support of Petitioners, pp. 3, 4, and 7-10, incl.

economic impact is not great, three states (Alaska, Montana, and North Dakota) continue to impose tax on a worldwide unitary basis. As I will discuss below, we also have concerns regarding elements of the California legislation. *We believe, however, that such significant progress has been made that restrictive Federal legislation is not warranted at this time. . . .* California has an opportunity to consider and respond to comments on its recently enacted legislation, and we have an opportunity to evaluate the actual operation of water's edge legislation passed by the several states when fully in effect.

* * *

" . . . States have moved away from the worldwide unitary method in part in reliance on the Administration's representations in this regard. To the extent possible without legislation, the Administration has already moved to provide greater assistance to the states. We continue to be committed to providing such federal support. . . .

"The progress made on this difficult issue is a tribute to the wisdom of President Reagan's decision in 1983 to seek a cooperative solution by convening a Worldwide Unitary Taxation Working Group, consisting of representatives from states, business and the Federal government, to address the issue. It is also a tribute to the leadership evidenced by the state officials and leaders of domestic and foreign-controlled multinationals that have together forged compromises in states across the country. We expect that these participants will continue to demonstrate the same leadership as we attempt to address the remaining concerns relating to the worldwide unitary tax issue." Letter from J. Roger Mentz, Assistant Secretary of the Treasury (Tax Policy) to George Deukmejian, Governor of California (April 8, 1987) (J.A. 24-27). Emphasis added.

Moreover, contrary to petitioners' assertions that California's method of taxation leads to justifiable foreign retaliation, see Brief for Petitioner Barclays, at p. 28, the evidence indicates that the business community, including foreign corporations (and specifically Barclays), contributed significantly to both the legislative process that produced the enactment of S.B. 85 and the regulatory process thereafter that implemented that legislation and, generally, received substantial unitary reform as a result of the legislative compromise that was forged. See Appendix B.

In 1993, as a part of the continuing dialogue between federal and California officials and the business community, the California Legislature enacted Senate Bill No. 671 (Ch. 881, Cal. Stats. 1993) to make substantial changes to the water's edge provisions, including, among other things, the elimination of the requirement that an election fee be paid and the authorization of a taxpayer to elect to account for and determine its income pursuant to a water's edge election for an 84-month period. S.B. 671 also deleted the previous requirement of filing a domestic disclosure spreadsheet and, instead, provided that each taxpayer required to apportion its income was to file an annual information return, as specified.[5]

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[5] It should be noted that the voluntary actions of the California Legislature in enacting water's edge legislation have come at times when the State has been facing multi-billion

Again, as in the case of S.B. 85, the California Legislature was responsive to the concerns of both the federal government and the business community, and vitually all of the unitary reforms that had been sought were enacted. See Appendix C.

Thus, it is apparent that over the years the California Legislature has exercised its sovereign power to tax with due recognition and responsible consideration of the concerns and desires of both the federal government and the business community with regard to California's use of worldwide combined reporting. At the same time, the federal government has respected the use of worldwide combined reporting by individual states in the exercise of their sovereign taxing power and, in response to complaints from multinational corporations, has instituted and adhered to a policy that requested only voluntary state action in adopting water's edge legislation.

C. Petitioners' Heavy Reliance on Federal Executive Communications as Constituting a Clear Federal Directive for Purposes of the Commerce Clause is Misplaced

The Commerce Clause of the Constitution of the United States grants the power to Congress, not the

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dollar budget deficits. For example, in 1993 the California Legislature was facing a budget deficit of over $7 billion. Nevertheless, even though future revenue collections were and remain uncertain (as of the time of this writing, a deficit of over $3.8 billion is projected for 1994), the California Legislature made the difficult choices of cutting vital programs and raising various other taxes, while still enacting S.B. 671.

Executive Department, to regulate foreign and interstate commerce. U.S. Const., Art. I, Sec. 8, cl. 3. Therefore, any action of Congress with respect to foreign commerce is certainly more determinative of federal policy in that regard than any desire or aspiration that may be expressed by individual representatives of the federal Executive. See *U.S. v. Curtiss-Wright Export Corp.*, 299 U.S. 304, 81 L. Ed. 255 (1936); *United States v. Guy W. Capps, Inc.*, 204 F. 2d 655, 658-660 (4th Cir. 1953), aff'd on other grounds, 348 U.S. 296, 99 L. Ed. 29 (1955).

Barclays' misplaced reliance on federal Executive communications as determinative of federal policy is also demonstrated in its criticism of the decision of the Supreme Court of California below, as follows:

> "The 'one voice' test proceeds from the strong presumption of the need for federal uniformity in the area of foreign commerce. *Japan Line*, 441 U.S. 434; *Wardair*, 477 U.S. 1. The decision of the court below sees no need for uniformity. Rather it invites state interference in foreign affairs unless Congress curbs the state. The California court would silence the Executive and in the silence of Congress permit a cacophony of state voices. Who can tell our foreign trading partners what the policy of the United States is? Can our foreign trading partners rely upon the responses of the Executive? Is this not exactly the situation which will lead to retaliation and harm to the nation as whole?" Petition for Writ of Certiorari by Petitioner Barclays, at p. 24. Footnote omitted.

Barclays' questions can be answered, in part, by posing the following question: Under our federal constitutional system, does the Executive Department have the authority to either enact a statute that would ban the use

of worldwide combined reporting by the States without Congressional approval, or to make a treaty that would ban the use of worldwide combined reporting by the states without obtaining the advice and consent of, and the concurrence of two-thirds of the membership of, the Senate? The answer obviously is no.

Even if it is conceded that the federal Executive has some measure of authority in this area, the federal Executive in fact has chosen only to request voluntary action by the States in enacting water's edge legislation to address the concerns expressed by some members of the business community. See, e.g., Chairman's Report and Supplemental Views, Final Report of the Worldwide Unitary Taxation Working Group (Aug. 1984), Office of the Secretary, Department of the Treasury; Letter from J. Roger Mentz, Assistant Secretary of the Treasury (Tax Policy) to George Deukmejian, Governor of California (April 8, 1987) J.A. 24-27.

D. Petitioners' Assertion That Worldwide Combined Reporting is Prohibited by Dormant Commerce Clause Analysis is Incorrect

Barclays sets out a number of events, most of which are subsequent to the enactment of Senate Bill No. 85 in 1986, and many of which occurred as recently as 1993, that disclose dissatisfaction or risk of retaliation by foreign governments. Brief for Petitioner Barclays, at pp. 10, 11. The only significant event preceding the enactment of Senate Bill No. 85 to which Barclays refers is the "retaliatory" legislation enacted in the United Kingdom in 1985. Barclays asserts that this legislation is the most obvious

foreign policy implication. Brief for Petitioner Barclays, at p. 27.

In response to petitioners' assertions regarding the risk of retaliation, amicus curiae submits that the fact that the United Kingdom negotiated and accepted the bilateral treaty which specifically excluded article 9(4), as originally negotiated, weighs strongly against the conclusion that the tax imposed by California might *justifiably* lead to significant foreign retaliation. See *Container Corp. v. Franchise Tax Bd.*, 463 U.S. 159, 194, 77 L. Ed. 2d 545, 572 (1983).

Barclays also relies on a number of events occurring subsequent to 1977, the latest tax year at issue, and purports to extrapolate therefrom a precise federal foreign policy that was in effect both prior to and during 1977: specifically, that the use of the arm's length method was required to be used by California. Brief for Petitioner Barclays, at pp. 5, 8, 23 to 25, incl. Pursuant to Barclays' reasoning, that policy is discerned through a dormant Commerce Clause analysis. Colgate makes a similar argument. Brief of Petitioner Colgate, at pp. 34, 35, 36, 40, 41, 42.

In this connection, petitioners assert both that the use of the arm's length standard was a critically important feature of foreign policy and that Congress took no action during the tax years at issue or in subsequent years, with respect to that precise and important foreign policy. Brief for Petitioner Barclays, at pp. 19 to 25, incl.; Brief of Petitioner Colgate, at pp. 6, 19 to 22, incl. If petitioners' claim of inaction by Congress is accepted, an interesting question is presented: If the specific foreign policy asserted by petitioners was so pressing and important,

why didn't Congress take any legislative action to ensure that the policy was implemented by the States?

The apparent contradiction raised by this question can be resolved rather simply. Congress *did* actually take action with respect to federal foreign commerce policy as it relates to worldwide combined reporting.

In this connection, amicus curiae submits that the fact that Congress has rejected various federal legislative proposals affecting the use of worldwide combined reporting by the states over a 20-year period commencing in 1965, see *Barclays Bank Internat., Ltd. v. Franchise Tax Bd.*, 2 Cal. 4th 708, 736, and the fact that a bilateral treaty was being negotiated at or about the time of the tax years in question, and that these negotiations were followed by the specific rejection of article 9(4), as originally negotiated, thereof by the United States Senate in 1978, see Remarks of Senators Cranston, Javits, and Pell, 124 Cong. Rec. 18400, 19076 (1978), make clear what federal foreign policy was for the tax years in question, irrespective of what that policy arguably may be currently. That policy was to not prohibit the continued use of worldwide combined reporting by the States.

For the foregoing reasons, amicus curiae submits that petitioners' assertion that worldwide combined reporting is prohibited by the inaction of Congress and dormant Commerce Clause analysis is incorrect.

E. The Application of Worldwide Combined Reporting to Petitioners Was Proper

The State of California, acting through the California Legislature, has exercised its sovereign power to tax

responsibly and with due deference to federal policy. The California Legislature recognizes that formulary apportionment has been approved for more than a century as a means of fairly dividing a single tax burden among several jurisdictions in which a taxpayer does business. The California Legislature recognizes that the Constitution grants to Congress, not the federal Executive, the power to regulate foreign and interstate commerce. The California Legislature is aware of the fact that Congress has specifically and continuously rejected any federal legislative ban on the use of worldwide combined reporting by the States.

The California Legislature is keenly aware of federal foreign commerce policy, and through California's large Congressional delegation, the State of California has contributed significantly to the formulation of that policy.

At the same time, the California Legislature is aware that federal policy can and does evolve over time. In this regard, the California Legislature has been closely attuned to the desires and concerns expressed by the federal Executive and the business community as exemplified by, among other things, the enactment in California of Senate Bill No. 85 and Senate Bill No. 671. However, the California Legislature believes that no foreign nation or corporation may dictate how the United States may conduct its foreign policy or how a State may conduct its sovereign power to tax.

Accordingly, amicus curiae submits that California's application of worldwide combined reporting to petitioners for the tax years at issue did not prevent the federal government from speaking with one voice when

regulating relations with foreign governments. Rather, the efforts of the California Legislature in enacting laws relating to worldwide combined reporting have been entirely consistent with the evolution of federal policy in this area, and have addressed specific concerns raised by the federal government and multinational corporations during that period of evolution.

CONCLUSION

For the foregoing reasons, amicus curiae urges this Court to affirm the decisions of the Court of Appeal of the State of California, Third Appellate District.

Respectfully Submitted,

BION M. GREGORY*
Legislative Counsel of California

JAMES A. MARSALA
Principal Deputy Legislative Counsel

BALDEV S. HEIR
MICHAEL R. KELLY
Deputies Legislative Counsel

Attorneys for Amicus Curiae
*Counsel of Record

APPENDIX A

To President Clinton from Senate Democrats

We want to take this opportunity to thank you for your past support of California's position in the Barclays Bank PLC tax case, which is before the U.S. Supreme Court. Despite an amicus curiae brief from the Solicitor General urging the Court not to take the case, the Court has decided to hear Barclays, as well as the related Colgate-Palmolive case. California is again turning to you for support.

Should the Supreme Court decide in favor of both Barclays and Colgate-Palmolive, California stands to lose $4 billion in tax revenues. You repeatedly have stated your belief that as long as California's economy is stalled in recession, the United States cannot truly emerge into prosperity. While we believe the California economy is on the road to recovery, the loss of $4 billion in tax revenue would be devastating to the state's coffers and the state's economy.

In the closing month of this year's legislative session, California made major concessions to the multinationals and their respective governments by amending the tax code to address their concerns. These steps were undertaken in a spirit of cooperation with your Administration. These changes along with significant modifications in the workers' compensation and other business tax areas were all part of our concerted effort to assure that California's recovery can become a reality.

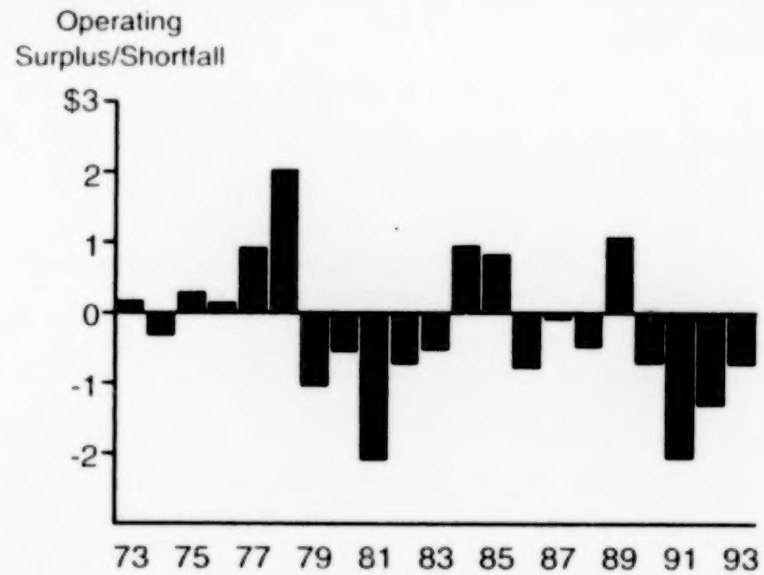
Your prior support of California on Barclays demonstrates your understanding of the need to protect the

taxing prerogatives of the states. It is vital that your Administration take an active role in supporting California before the Supreme Court. We urgently request that the Solicitor General be instructed to file an amicus brief in support of California in this matter. The deadline for filing briefs in support of California is January 14, 1994.

California's economy – and that of the nation – is in jeopardy. We need your help in order to prevail in this vital matter.

General Fund Operating Shortfalls Have Been Common In Recent Years[a]

(In Billions)



[a] Data are for fiscal years ending in year shown.

- Since Proposition 13 was approved in 1978, state General Fund spending has exceeded revenues in all but 3 years.
- 1992-93 will be the fourth consecutive year of operating shortfalls, resulting in an estimated 1992-93 ending budget deficit of $3.4 billion (absent corrective action).
- Operating shortfalls occurred even during the economic expansion of the mid-1980s.
- The relative size of the shortfalls has shrunk. The $2.1 billion 1980-81 shortfall was 9.9 percent of spending, but the $2.1 billion 1990-91 shortfall was only 5.1 percent of spending.

APPENDIX B

CALIFORNIA SCHOOL EMPLOYEES ASSOCIATION

Governmental Relations Office • 1127 11th St., Ste., 346 • Sacramento, CA 95814 • (916) 444-0598

March 17, 1986

TO: Assemblyman John Vasconcellos, Chairman and Members of the Assembly Ways and Means Committee

RE: SB 85 (Alquist) - OPPOSE

The California School Employees Association regretfully must oppose SB 85, to repeal the unitary method of taxiation [sic]. This measure is scheduled to be heard in your committee on Wednesday, March 19.

SB 85 will result in substantial tax breaks for multinational corporations, resulting in decreased revenues to the state. Combined with the impact of Gramm-Rudman the state will suffer from severe revenue losses and our experience leads us to the conclusion that our members will suffer. Not only will we suffer from reduced funding to schools which may cost us jobs, we could also be forced to pick up the slack by paying future tax increases.

All the data we have reviewed leads us to the conclusion that the repeal of the unitary tax will not substantially increase investment in California. California has led the nation in new investment despite the existence of the unitary taxation method.

We therefore urge your "NO" vote on SB 85.

Sincerely,

CALIFORNIA SCHOOL EMPLOYEES ASSOCIATION

/s/ Dave Low SR
Dave Low
Governmental Relations Representative

DL/sb
cc: Samuel Yockey
Legislative Analyst

THE NATION'S LARGEST CLASSIFIED SCHOOL EMPLOYEE ASSOCIATION

CALIFORNIA FIRST BANK

[Logo]

OFFICE OF THE PRESIDENT, LOS ANGELES
616 WEST 6TH STREET, LOS ANGELES, CALIFORNIA 90017
(213) 972-5260

YOSHIAKI SHIBUSAWA
EXECUTIVE VICE PRESIDENT

March 22, 1985

The Honorable William P. Baker
3013 State Capitol
Sacramento, CA 95814

Dear Mr. Baker:

I wish to thank you once more for taking time from your busy schedule to discuss the unitary tax reform bills. As you know, California First Bank is most concerned about the provision in the bills which deal with

the inclusion or exclusion of foreign banks from the "water's edge" group. I very much appreciated your willingness to listen to our point of view on this issue and, if I may, I would like to take this opportunity to reiterate it in writing.

The provision in the August 28, 1984 draft of Senator Alquist's SB 1437 concerning this issue is:

> "[A taxpayer shall include the following entities in the water's edge group] . . . (7) Any affiliated bank or corporation, regardless of the place where it is incorporated, if more than 20% of its payroll, property or sales is assignable to a location within the United States."

If a foreign bank exceeds this 20% threshold, then its U.S. subsidiary would be required to include the foreign bank in a unitary tax return for the water's edge group and thus the U.S. subsidiary would *not* benefit under the proposal. The Bank of Tokyo, Ltd., the parent corporation of California First Bank will fail to be excluded from the unitary tax return of California First Bank under this threshold provision, and we request that certain technical changes be made to change this result.

For most foreign corporations, the threshold issue is not significant, because foreign corporations generally operate in the U.S. through subsidiaries and therefore have *no* direct presence in the United States. It is also relatively easy for a foreign corporation to convert a branch into a subsidiary.

The banking industry, however, is subject to unique regulatory constraints which are not imposed on corporations in general. In particular, existing bank regulatory

and licensing procedures have caused foreign banks to establish agency and branch offices in the United States. Also, it is generally not feasible to convert an agency or branch into a subsidiary. Because these agencies and branches are not separate subsidiaries, the factors of such agencies and branches in the Unites [sic] States are taken into account when applying the threshold test.

Our particular problem with the proposed threshold test is that the Bank of Tokyo, Ltd. would be included in California First Bank's unitary tax return, because currently its "sales" (gross revenues) assignable to locations within the United States may be as high as 28%. Yet the average of its payroll and property factors is only about 10%. One reason the sales factor is much higher than the other two factors is that the sales factor is inflated by the substantially higher interest rates in the United States as compared with Japan. The sales factor is also volatile, because it is impacted by currency fluctuations and changing market conditions. The technical change California First Bank requests is to change the threshold test for foreign banks. Instead of a 20% property, payroll or sales test, the test for foreign banks could be a 20% property or payroll test. This would eliminate the unpredicability [sic] of the sales factor. Alternatively, a three factor average of 20% could be used. This would at least lessen the significance of the sales factor. We also note that averaging the three factors is similar to the general formula apportionment method. The adverse effect on state revenue by making this type of technical change for the foreign banking industry should not be substantial.

Of all the Japanese-owned companies in California, California First Bank is the largest contributor to the state's employment. California First Bank employs over 4,000 California residents statewide. It would be ironic if the U.S. subsidiary with one of the largest California payrolls would be the one subsidiary which is not protected by unitary tax reform. It is also significant that 98% of all of the shareholders of California First Bank are U.S. residents (although 76.6% of the total shares are held by The Bank of Tokyo, Ltd.). It would also be ironic if the U.S. subsidiary with one of the largest groups of U.S. shareholders were not protected by unitary tax reform, since under the circumstances about 23% of the unitary tax is actually borne by those U.S. shareholders.

In summary, California First Bank requests that you support the water's edge approach developed by Senator Alquist last year (and reintroduced this year as AB No. 157 by Assemblyman Dennis Brown) with one technical modification. California First Bank requests that the threshold test be modified so that foreign banks are included within the water's edge group *only if* the property or payroll factors of the foreign bank is greater than 20% (or alternatively, only if the average of the property, payroll and sales factors is greater than 20%). California First Bank would be most appreciative of your kind and thoughtful attention to this matter.

Sincerely yours,

/s/ Yoshiaki Shibusawa
Yoshiaki Shibusawa
Executive Vice President

CASTLE & COOKE, INC. FIFTY CALIFORNIA STREET SAN FRANCISCO, CA 94111
TELEPHONE (415) 986-3000
TELEX 340295

R. D. COOK
PRESIDENT

August 21, 1985

The Honorable William Baker
Vice Chairman, Ways and Means Committee
State Capitol
Sacramento, California 95814

Dear Mr. Baker:

On behalf of Castle & Cooke, Inc., an agricultural company employing over 10,000 Californians, we assure you Unitary Tax Reform is a major concern to our company and our employees.

On August 28, 1985, as Vice Chairman of the Ways and Means Committee, you will review Unitary Tax Reform for California. All that our company and its employees request is equity.

The management of Castle & Cooke, Inc. was very concerned about what was going to happen to our 10,000 California employees while we were on the brink of bankruptcy in the spring of this year. Passage of a Unitary Tax Reform Bill which favors foreign-based companies will reverberate as a message that California legislators are not concerned about employment for these 10,000 Californians.

Senate Bill 85 will reduce the California tax expense for our foreign competitors while keeping ours at its current level. No tax benefit flows to Castle & Cooke, Inc. in SB 85 while a sizeable benefit flows to our foreign competitors.

Why would you want to provide a tax incentive to foreign-based multinationals which tips the scales of cost competitiveness even further? The huge trade imbalance with our foreign trading partners indicates no such incentive is required.

Castle & Cooke, Inc. respectfully requests that you express support for American business and vote NO on SB 85.

We would greatly appreciate hearing your thoughts on Unitary Tax Reform and if you have any questions, please let us know.

Sincerely,

/s/ R. D. Cook
R. D. Cook, President
CASTLE & COOKE, INC.

Western
Union
Mailgram [Logo]

WUTELCO
1116 12TH STREET
SACRAMENTO CA 95814 23AM

1-0148271235006 08/23/85 TWX WU PUBTLX SAC SACB
06 SACRAMENTO CA 23-AUG-85

ASSEMBLYMAN WILLIAM BAKER
ROOM 3013
STATE CAPITOL
SACRAMENTO, CA 95814

DEAR

IT SEEMS THE COMPLICATIONS SURROUNDING UNITARY TAX REFORM ARE NEVER ENDING. NOW, A NEW AND UNFORSEEN [sic], BUT MOST SIGNIFICANT PROBLEM HAS ARISEN WHICH COULD ENCOURAGE FOREIGN-OWNED CALIFORNIA BANKS TO LIMIT EXPANSION IN CALIFORNIA, REDUCE THEIR PAYROLLS AND THE NUMBER OF PEOPLE EMPLOYED. THIS WOULD, OF COURSE, BE CONTRARY TO THE INTENT OF SENATE BILL 85.

AS YOU KNOW, ON JULY 18, SB 85 WAS AMENDED TO HELP REDUCE THE TAX COMPLIANCE BURDENS OF FOREIGN BANKS WITH U.S. BRANCHES. THESE AMENDMENTS, WHILE TAKING CARE OF ONE PROBLEM, INADVERTANTLY AND IRONICALLY, CREATED ANOTHER.

VERY SIMPLY, FOREIGN-OWNED CALIFORNIA BANKS WHICH EMPLOY LARGE NUMBERS OF CALIFORNIANS, 28)) 0-6 #8&#34 '5-53 8,:9.3 5-/3' 7,ER SB IT [missing text in original] AS AMENDED, SOLELY

BECAUSE THEY EMPLOY LITERALLY THOUSANDS OF CALIFORNIANS AND HAVE, THEREFORE, SUBSTANTIAL CALIFORNIA PAYROLLS.

THIS ADDITIONAL BURDEN OCCURS BECAUSE OF STRUCTURAL FEATURES IN THE BANKING SYSTEM WHICH CANNOT BE EASILY CHANGED; PRIMARILY HIGH EMPLOYMENT FIGURES BY LARGE CALIFORNIA RETAIL BANKS AND LOW EMPLOYMENT FIGURES IN U.S. BRANCHES OF FOREIGN BANKS (PRINCIPALLY NEW YORK) WHICH DO NOT CONDUCT RETAIL BANKING. UNDER SB 85, AS AMENDED ON JULY 18, THESE U.S. BRANCHES OF FOREIGN BANKS ("DEEMED SUBSIDIARIES") WILL BE COMBINED WITH CALIFORNIA RETAIL BANKS FOR TAX PURPOSES.

JAPANESE-OWNED CALIFORNIA BANKS EMPLOY MORE THAN 100,000 CALIFORNIA RESIDENTS. AS A RESULT, THEIR CALIFORNIA PAYROLL FACTORS RANGE FROM 70-80 PERCENT WHEN CALCULATED FOR A WATER'S EDGE GROUP WHICH INCLUDES A "DEEMED SUBSIDIARY" OF A FOREIGN PARENT BANK. BUT, THE CALIFORNIA SALES AND PROPERTY FACTORS OF SUCH A GROUP WOULD BE MUCH LESS, OFTEN 20-40 PERCENT. THIS IMBALANCE WILL RESULT IN AN INCREASE IN THE CALIFORNIA TAXES OF A CALIFORNIA BANK SIMPLY BECAUSE IT EMPLOYEES [sic] A LOT OF PEOPLE AND HAS A HIGH PAYROLL FACTOR.

THIS NEW PROBLEM CAN BE SOLVED EITHER (I) BY EXTENDING THE APPLICATION OF THE 20 PERCENT AVERAGE THRESHOLD TEST CURRENTLY IN THE BILL (AND WHICH IS APPLICABLE TO FOREIGN CORPORATIONS) TO FOREIGN BANKS OR (II) BY PERMITTIG [sic] FOREIGN BANKS TO ELECT TO BE TAXED LIKE FOREIGN CORPORATIONS FOR PURPOSES OF APPLYING THE WATERD'S [sic] EDGE PROVISIONS. WE REQUEST THAT YOU CONSIDER THESE ALTERNATIVES.

1. CALIFORNIA FIRST BANK (PHONE 213-972-5260 C/O MR. SHI BUSAWA) SISHICHI ITOH, PRESIDENT.

2. GOLDEN STATE SANWA BANK (PHONE 213-614-0400) TERUYOSHI YASUFUKU, CHAIRMAN AND PRESIDENT.

3. THE MITSUBISHI BANK OF CALIFORNIA (PHONE 213-621-1200). TSUNEYOSHI KAJIWARA, PRESIDENT.

4. THE SUMITOMO BANK OF CALIFORNIA (PHONE 415-445-8151). TERUHISA SHIMIZU, PRESIDENT.

WU TELTEX SAC

15:47 EST

MGMCOMP

[Logo] California Teachers Association

GOVERNMENTAL RELATIONS DEPARTMENT

1127 Eleventh Street, Suite 450,
Sacramento, California 95814
(916) 442-5895

August 23, 1985

The Honorable William Baker
Member, Assembly Ways & Means Committee
State Capitol, Room 3013
Sacramento, CA 95814

Dear Assemblymember Baker:

The California Teachers Association is *opposed* to SB 85 (Alquist). The repeal or limitation of the unitary method will cause a substantial and continuing loss of state revenues. And, we believe any significant reduction in state revenues will reduce funding available for the public school system of this state.

We respectfully urge your "*NO*" vote when SB 85 is heard by the Ways and Means Committee.

If you have any questions or concerns regarding our position on this measure, please contact CTA Legislative Advocate Rachel A. Joseph at (916) 442-5895.

Sincerely,

/s/ Alice A. Huffman
Alice A. Huffman
Director of Political Affairs

AAH/RAJ/dh

[Logo]
California Chamber of Commerce

1027 10th Street, 4th Floor
• P.O. Box 1736 • Sacramento, CA 95808 •
(916) 444-6670

August 23, 1985

The Honorable William Baker
California State Assembly
State Capitol
Sacramento, CA 95814

Dear Mr. Baker:

Subject: ***SB 85 (Alquist) Unitary Tax Reform***

The California Chamber of Commerce has reviewed ***SB 85 (Alquist)*** *and* ***opposes*** *the bill in its current form. The Chamber believes reform of the unitary tax is essential to continued job growth and economic development in California. SB 85 shows a recognition of the need for change by allowing companies the ability to file tax returns under a water's-edge combination rather than the worldwide method of combination. However, the California Chamber does not feel SB 85 achieves sufficient reform. The Chamber's position is based on the following reasons:*

1. Foreign source income of American companies is still subject to tax. *Worldwide unitary combination is inappropriate tax policy because it taxes foreign income. SB 85 allows companies to elect water's-edge combination, but taxes foreign dividends which are returned to the United States. For American companies, this means they are still subject to tax on that foreign income. The American companies must not only pay tax on the foreign source income, but by electing water's-edge*

treatment they do not have the benefit of the factor relief that the foreign operations provide.

*2. **SB 85 puts American business at a competitive disadvantage.** Because SB 85 taxes the foreign source income of American multinationals, but not foreign multinationals, American companies [are] at a competitive disadvantage. California's business community operates on a worldwide scale. They are able to compete with anyone in manufacturing and sales if they are given an equal playing field. But, American business cannot compete with a tax policy that gives their foreign competition a built-in advantage.*

*3. **Unitary reform should not increase other taxes or fees.** SB 85 requires companies electing a water's-edge combination to pay an offsetting tax. The "levy" is clearly a tax because it goes to fund general governmental services, there is no relationship between the amount of the levy and the benefit received by the payor, it is levied on the same basis as the current unitary tax, and it goes on indefinitely.*

The economic growth resulting from unitary reform will mean more property and sales tax revenue to local governments, and income taxes to the state from new employees.

The California Chamber of Commerce has a broad policy on the reform of the unitary tax, which I have enclosed. The Chamber is open to discussion of that policy and any possible agreement. We have indicated this position to Senator Alquist. We hope that he would amend his bill in line with that policy, or in the alternative back to the version of the bill as amended January 24.

In its current form, the California Chamber of Commerce urges a NO vote on SB 85.

Sincerely,

/s/ Fred L. Main
Fred L. Main
Manager/Tax Counsel
Taxation Group

FLM:jrr
Enclosure

ORGANIZATION FOR FAIR TAXATION
OF INTERNATIONAL INVESTMENTS
100 MANHATTANVILLE ROAD
PURCHASE, NEW YORK 10577

NEIL H. GREEN
CHAIRMAN
(914) 251-3961

January 15, 1988

California Franchise Tax Board
Legal Department
Attention: Ms. Susan Borgman
P.O. Box 1468
Sacramento, California 95807-1468

Comments on Proposed Reglations [sic] *25110, 25111, 25112, 25114, and 25120*

Dear Ms. Borgman:

The attached comments are made pursuant to the published invitation of the Franchise Tax Board.

OFTII is a Delaware non-profit corporation, whose members are U.S. subsidiaries of foreign corporations. OFTII

was organized to represent its members' interests in matters relating to Federal and State taxation. OFTII members have very substantial investments in the United States, including significant investments in the State of California. A list of OFTII members showing the nationality of each member's foreign parent is attached.

I trust that our comments will be useful to you. Should you have any questions, please call me at the number above. If you would like to have a detailed discussion of these comments, we would be pleased to organize a visit to Sacramento by one or more of our members.

Yours sincerely,

/s/ N. H. Green
N. H. Green

NHG/ys
Attachments

OFTII MEMBERS

AKZO America, Inc.	Holland
Alcan Aluminum Corporation	Canada
Allied Lyons North Anmerica [sic]	United Kingdom
Barclays Bank	United Kingdom
Batus, Inc.	United Kingdom
British Petroleum of North America	United Kingdom

BASF American Corporation	Germany
Beecham, Inc.	United Kingdom
Elf Aquitaine, Inc.	France
Foseco Minsep	United Kingdom
Gold Fields American Corp.	United Kingdom
GKN North America, Inc.	United Kingdom
American Hoechst Corporation	Germany
ICI Americas, Inc.	United Kingdom
Moet et Chandon	France
Nestle Holdings, Inc.	Switzerland
Shell Oil Company	UK/Holland
Siemens Capital Corporation	Germany
Sony Corporation of America	Japan
Volkswagen of America	Germany
Volvo of America	Sweden
Unilever United States	UK/Holland
Thorn EMI (USA), Inc.	United Kingdom

31 October 1988 [Logo]

ORGANIZATION FOR
FAIR TREATMENT OF
INTERNATIONAL
INVESTMENT INC.

Wilmington, DE 19897
Tel. (302) 575-3738
Fax. (302) 575-2952

California Franchise Tax Board
P.O. Box 1468
Sacramento, CA 95807-1468

Comments on proposed Regulations 24344(c), 24411, 25110, 25111, 25112, 25114, 25115, and 25401d.

These comments are offered pursuant to the published invitation of the Board.

OFTII is a nonprofit corporation all of the members of which are domestic taxpayer corporations owned or controlled, directly or indirectly, by nondomestic shareholders or corporations. OFTII members have very substantial investments in the United States, including the State of California. There is annexed a list of OFTII members on whose behalf these comments are submitted.

The Board are to be commended for proposing revised regulations that consist with the amended version of SB 85 so soon after that Act's adoption. The second annexure contains some observations of technical problems in a few paragraphs of the revised proposals. These observations do not denigrate the fact that, on the whole, the Board have done a very good job of interpreting SB 85 in a reasonable manner. The principal difficulty noted by OFTII is not the text the regulations proposed, but the

subjects that they *do not cover*: namely, the fundamental problems of who is subject to worldwide combined income reporting and apportionment and, hence, who is properly constrained to make the water's edge election provided in Reg. 25110. This issue is much broader than Reg. 25110, itself. The attempt to resolve these issues by simply referring to cases decided by the United States Supreme Court, the California courts, and the State Board of Equalization (see Reg. 25110, subdivision (d)) provides no real guidance for taxpayers or Board auditors and will simply produce more litigation as these issues are contested on a case by case basis.

The attempt to define a "unitary business" in eleven lines in Reg. 25110(b)(4) does nothing to clear up the enormous confusion that has been the source of years of litigation concerning who is and who is not subject to UDITPA apportionment. In July 1987, the Franchise Tax Board circulated a discussion draft of proposed regulations entitled "Determination of Separate or Unitary Business," numbered 25120(b). These regulations were never listed for hearing and, so far as taxpayers are aware, never progressed past the discussion stage. While there were a number of specific problems with those proposed regulations, they endeavored to fill a pressing need: The establishment of guidelines for the determination of such important basics as who is a "taxpayer" and what is a "unitary group." The State Board of Equalization recently noted the ambiguity that exists in existing regulations concerning the meaning of "taxpayer." In *Appeal of Finnigan Corp.* 88-SBE-022, pp. 161-162 (1988) the Board stated with reference to Reg. 25121(d), that "the word 'taxpayer' is used in, at least, two senses; one in which

the taxpayer is taxable in California, and another in which the 'taxpayer' is not taxable in the state." The United States Court of Appeals for the Seventh Circuit has recently upheld the right of foreign companies whose income was apportioned to California to maintain actions *in federal court* to challenge that apportionment because California refused to grant these foreign companies access to California Courts. *Alcan Alum. v. Franchise Tax Bd.* No. 87-2239, 19 October 1988. The need for clear and workable definitions must be met to avoid even greater confusion and more litigation in the future.

There is a particular need for definitions of "centralized management," "functional integration," "taxpayer," "taxpayer group," and "trade or business," just to name some of the more obvious. Most of the taxpayer disputes with the FTB that have arisen over the last few years have grown out of claims of arbitrary determinations of FTB auditors in deciding who is subject to apportionment, and what types of income are to be included. E.g., Alcan Aluminium Ltd., Shell Oil Corp., EMI Ltd., Imperial Chemical Industries, Barclay's Bank, and Container Corp., just to name some taxpayers who have gone to court or are still in court to press their claims that income was unfairly or improperly apportioned. These issues will not go away until some clear guidelines are established for the benefit of taxpayers and FTB auditors alike. The place to start is with the definitional regulations.

OFTII will be pleased to discuss in detail any matters relating to regulations with Board members or with staff, if such discussion would prove helpful. Please call the

undersigned if it is believed that OFTII can be of assistance.

/s/ Illegible Signature
J.M. Carter
Secretary

Annexures (2)

Directors: Harry Corless, Chairman • Ned W. Bandler • Robert E. Dillon • Donald J. Kapraly • Leonard D. Levin • Alex Spitzer

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UNITARY TAX CAMPAIGN

Unitary Tax Campaign Limited
19 Catherine Place, London SW1E 6DX
Tel: 01-630 5651
Facsimile: 01-821 1490 Telex: 296438 IGAUK G

CAMPAIGN CO-ORDINATING COMMITTEE:
BAT Industries plc., Barclays Bank plc.,
Foseco Minsep plc., Glaxo Holdings plc.,
Hawley Group plc., Imperial Chemical Industries plc.,
National Westminster Bank plc.,
CAMPAIGN ADVISERS:
Ian Greer Associates Limited

January 26, 1988

BY FEDERAL EXPRESS

California Franchise Tax Board
Legal Division
Post Office Box 1468
Sacramento, California 95807-1468
U.S.A.

Attn: Susan Borgman

RE: Unitary Tax Administrative Regulations

Dear Ms. Borgman:

The Unitary Tax Campaign (UTC) and the Confederation of British Industry (CBI) which represent British international companies that have investments in the United States, are pleased to have the opportunity to comment on the proposed administrative regulations.

We have, as you are well aware, consistently opposed the use of worldwide unitary taxation and continue to do so. We welcome in the legislation recognition of the problems created for British business by the use of worldwide unitary tax, but have a number of very serious reservations about it which we have set forth over the years in various communications to interested parties, including the Franchise Tax Board. These include the election fee, the lengthy election period, the continued ability of the Franchise Tax Board to throw taxpayers back onto worldwide combined reporting and the continued compliance burdens. We believe that the combination of these measures will lead to almost all companies not electing. Unfortunately, the legislation and now the regulations, create more uncertainty than ever before. Seeing the two in combination makes us realize that we have a substantial way to go in resolving the difficulties of the unitary problem.

Nevertheless, we are enclosing detailed comments on the draft regulations. We have substantial difficulties with segments of the legislation itself, but we have for the most part confined our comments to the regulations. We strongly believe that the regulations go far beyond the letter and spirit of the legislation passed in September, 1986.

We would be very happy to discuss with you any of the points we have made if you feel that such a meeting would be beneficial. Finally, we hope that the commitment to limiting the use of worldwide unitary tax can be translated into satisfactory and effective legislation and regulations.

Yours sincerely,

/s/ Peter J. Welch/j
Peter J. Welch,
Chairman,
Unitary Tax Campaign

/s/ Keith McDowall/j
Keith McDowall
Deputy Director-General
Confederation of British Industry

UNITARY TAX CAMPAIGN

Unitary Tax Campaign Limited
19 Catherine Place, London SW1E 6DX Tel: 01-630 5651
Facsimile: 01-821 1490 Telex: 296438 IGAUK G

CAMPAIGN CO-ORDINATING COMMITTEE:
BAT Industries plc., Barclays Bank plc.,
Foseco Minsep plc., Glaxo Holdings plc.,
Hawley Group plc., Imperial Chemical Industries plc.,
National Westminster Bank plc.,
CAMPAIGN ADVISERS:
Ian Greer Associates Limited

28th June, 1988.

Ms. Susan Borgman,
California Franchise Tax Board,
Legal Division,
Post Office Box 1468,
Sacramento,
California 95807-1468
United States of America.

Dear Ms. Borgman,

UNITARY TAX ADMINISTRATIVE REGULATIONS

We are enclosing detailed comments on the second draft of the regulations.

We are very concerned that only one of our substantive comments, on the earlier draft, has been accepted by the FTB. It is fair to say that it is not one of our major points of principle. The UTC and CBI continue to see the regulations as going beyond the spirit and letter of the original legislation, which both the UTC and CBI did not feel able to support.

British business does not think that where we are will solve the problem. A combination of the election fee, the election period, the absence of refund provisions, the 'throw back' provisions and the tone of the second draft of the regulations (and the implications for compliance) are seen by British business as reason for not electing for 'water's edge'. In fact, no member of the UTC currently expects to elect and we understand that, at a meeting earlier this year in the US, only three companies out of about two hundred indicated an expectation of electing. It was interesting that the US Treasury and representatives of the Governor's office in Washington and London, confirmed our analysis that the problem has not been solved.

We would be happy to discuss with you any of the points we have made.

Yours sincerely,

/s/ Andrew Smith
pp
PETER J. WELCH
Chairman
Unitary Tax Campaign

/s/ Andrew Smith
pp
KEN EDWARDS
Deputy Director-General
Confederation of British Industry

UNITARY TAX CAMPAIGN

Unitary Tax Campaign Limited
19 Catherine Place, London SW1E 6DX Tel: 01-630 5651
Facsimile: 01-821 1490 Telex: 296438 IGAUK G

CAMPAIGN CO-ORDINATING COMMITTEE:
BAT Industries plc., Barclays Bank plc.,
Foseco Minsep plc., Glaxo Holdings plc.,
Hawley Group plc., Imperial Chemical Industries plc.,
National Westminster Bank plc.,
CAMPAIGN ADVISERS:
Ian Greer Associates Limited

1st November, 1988.

Ms. Susan Borgman,
Legal Division,
California Franchise Tax Board,
PO Box 1468,
Sacramento,
California 95807-1468
United States of America.

Dear Ms. Borgman,

UNITARY TAX ADMINISTRATIVE REGULATIONS

We are enclosing detailed comments on the amended version of the second draft of the regulations.

We would be happy to discuss with you any of the points we have made.

Yours sincerely,

/s/ Andrew Smith pp PETER J. WELCH Chairman Unitary Tax Campaign	/s/ Andrew Smith pp KEN EDWARDS Deputy Director-General Confederation of British Industry

---

TIM LESLIE
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COMMITTEE SECRETARY
BARBARA BESSON

California State Senate

COMMITTEE
ON
BUDGET AND FISCAL REVIEW

ROOM 5013, STATE CAPITOL
SACRAMENTO, CALIFORNIA 95814
(916) 445-5202

ALFRED E. ALQUIST
CHAIRMAN

July 14, 1993

Kirk West, President
California Chamber of Commerce
12th Floor, 1201 K St.
Sacramento, CA 95812-1736

Dear Kirk:

In 1986, after several years of intense discussion and negotiation, the California Legislature passed and the Governor approved my SB 85, which provided for a water's edge election. Under this legislation it is now

possible for a multinational group of corporations operating a unitary business to elect to have their California income share determined on a "water's edge" basis rather than under the traditional "worldwide combination" method. The election is accomplished by entering into a contract with the State for a minimum term of five years. The contract requires the taxpayer to comply with certain documentation requirements, to include certain income within the water's edge base, and to pay a relatively modest "election fee" (equal to 0.03% of the sum of it's [sic] California payroll, property and sales factors).

Although there has been scattered grumbling about some of the terms of the water's edge election, generally the business community has been pleased with the results of the SB 85 compromise. However, persistent complaints from some foreign-owned companies and their governments have prompted me to consider a serious review of California's treatment of multinational businesses.

As a beginning step toward that end, Senators Roberti and Maddy have joined me in amending SB 671 to require that our current water's edge method no longer be elective, but be mandatory on all worldwide groups of corporations doing business in California. This approach has not been greeted warmly by the domestic multinationals and it does not necessarily conform with what my colleagues in the Senate and I believe to be the appropriate reform. Therefore, SB 671 was amended in the interest of discussing the issues surrounding unitary taxation in the mid-1990's, and to serve as the vehicle for potential modifications should these prove necessary.

I have attached a chart outlining a range of alternatives to the current water's edge approach, which may serve to frame the broader aspects of the issue for our hearing in the Senate Revenue and Taxation Committee on August 18.

One factor which I should emphasize above all else is that any reform to our present unitary method must not serve as an opportunity to derive additional tax concessions from the State of California which would further erode the state's precarious fiscal position.

Please let me know your views on potential reforms to the water's edge method, so that we may all understand where everyone stands on the issue.

Sincerely,

/s/ Alfred E. Alquist
ALFRED E. ALQUIST

cc: Other Interested Parties

Unitary Options

1. Do nothing (leave SB 85 water's edge approach in place)	This "null" approach would be unlikely to placate the British and it would not lend support to a U.S. administration position that "California is doing it's part to resolve this difficulty." However, in face of some alternatives, a large number of domestic-based corporations would prefer this option.	Revenue neutral
2. Adopt "mandatory water's edge" approach (SB671 – Alquist)	Apparently requested by both U.S. Treasury AND British representatives, this approach would disadvantage a large number of mainly domestic-based corporations who prefer (for reasons of tax minimization) to remain under world-wide combination.	Revenue gain of $100 plus million, which could be balanced by a reduction in the franchise tax rate from 9.3% to 9.1%
3. Revert to pre-SB 85 system (mandatory worldwide combination)	SB 85 (Alquist – 1986) was a heroic attempt to resolve domestic and international concerns over our worldwide method. If British retaliation is a sign that the attempt was an utter failure, then perhaps it should be abandoned.	Revenue gain of $300 plus million (which could be balanced by a rate reduction do 8.7%)
4. Take a step beyond SB 85 by providing a permanent election to use water's edge OR worldwide combination, with no election fee.	If the SB 85 election-with-fee structure was considered a temporary stopgap and an attempt to extract a *quid pro quo* from those electing water's edge, then perhaps the time has come to consider "normalizing" the system by treating water's edge on a par with worldwide combination. (This option would also involve removing FTB's ability to disregard the election, and perhaps the domestic disclosure spreadsheet (DDS).)	Revenue loss of $100 million (about half of which would be loss of the election fee). Could be balanced by an increase in tax rate to 9.5%.
5. Adopt AB 2084 (Takasugi), which repeals the DDS and the FTB disregard power.	A minimalist response, which could serve to test the proposition that the point which angers the British the most is FTB's power to unilaterally disregard the election.	Relatively minor and speculative revenue loss if a monetary penalty is substituted for FTB's disregard power.
6. Adopt a hybrid system, which would (1) continue the election fee for those who wish the option of reverting to worldwide at some time, and (2) provide a permanent election (as in 4. above) for those who wish to avoid the election fee.	This option would contain the features of 4., above, and would test the notion that unitary corporate groups would desire the option of electing OUT of water's edge should events turn out differently than planned.	Revenue loss of less than $100 million, to the extent that some groups would continue to use the temporary election, and pay the fee. A tax rate of between 9.3% and 9.5% might balance the package.

Note that all revenue estimates mentioned above are speculative, and would need to be confirmed by FTB and Finance.

Senate Rev & Tax mh July 13, 1993

APPENDIX C

CBI

Confederation of British Industry
Centre Point
103 New Oxford Street
London WC1A 1DU
Telephone 01-379 7400
Telex 21332
Facsimile 01-240 1578

From
Maurice Hunt
Deputy Director-General

17 August 1993

The Hon David A Roberti
President pro Tempore
California State Senate
State Capitol
Room 205
Sacramento
California
95814
USA

Our ref 08/07

Dear Senator Roberti,

Unitary Taxation

I am writing to you in connection with the discussions on unitary taxation about to take place in the Californian [sic] Legislature.

Unitary taxation on a worldwide combined reporting basis is a matter which is of vital importance and increasing concern to British business. Our concern has been reflected in the action we have taken over the years both in California and elsewhere in the United States by way of submission of written and oral evidence in relevant legislative and judicial proceedings with a view to securing its curtailment.

To assist in the current deliberations I am enclosing some material which explains more fully the problems which California's unitary tax system creates for British companies wishing to establish themselves in or do business with California.

If you would like further copies we shall be pleased to provide them. I hope that you will find this material helpful as a guide to how we in British business see the situation overall.

If there is any further assistance we can provide please do not hesitate to let me know.

Yours sincerely,

/s/ Maurice Hunt
Maurice Hunt

Enc.

CBI

Confederation of British Industry
Centre Point
103 New Oxford Street
London WC1A 1DU
Telephone 071-379 7400
Facsimile 071-240 1578
Telex 21332

From
Maurice Hunt
Deputy Director-General

27 August 1993

Mr Fred Silva
Chief Consultant
Fiscal Unit
State Capitol, Room 400
Sacramento
California 95814
USA

Our Ref. 08/07

Dear Mr. Silva,

Californian Unitary Tax: SB671 (amended 23/8/93)

In our position paper on Californian unitary tax which we sent you earlier this month we explained a number of difficulties which British business had identified with the existing Californian unitary tax legislation in the hope that our explanation would be of assistance to you in the current review of this tax, in particular the debates on SB671.

Following the amendments made to SB671 up to 23 August 1993 we are pleased to note that a number of our concerns have been acknowledged by the Californian

authorities as warranting changes to the unitary tax regime.

At the same time however there remain a number of serious concerns which still need to be addressed. We offer some further thoughts on these based on the amended text of SB671.

Again we put these forward in a constructive spirit with a view to assisting in the crafting of legislation to meet the fundamental difficulties which we identified in our previous paper. Our central objective in this is to ensure that taxpayers have an unconditional entitlement to water's edge treatment.

Yours sincerely,

/s/ Illegible Signature
pp
Maurice Hunt

Enc.

NATIONAL FOREIGN TRADE COUNCIL, INC.

1625 K STREET, N.W., WASHINGTON, DC 20006

Tel: (202) 887-0278 [LOGO] FAX: (202) 452-8160

NEW YORK OFFICE:
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• TEL: (212) 399-7128 • FAX: (212) 399-7144

August 12, 1993

The Honorable David Roberti
California State Senate
Capitol Building
Room 205
Sacramento, CA 95814

Dear Senator Roberti:

The National Foreign Trade Council, Inc. (NFTC) appreciates the opportunity to comment on prospective legislation (S.B. 671) being considered by the California legislature to revise the method by which foreign and domestic multinational companies are taxed on their business operations in California.

The NFTC is a trade association with some 500 members, founded in 1914. Its membership consists primarily of U.S. corporations engaged in all aspects of international business, trade, and investment. The NFTC's objective is to encourage policies that will expand U.S. exports and enhance the competitiveness of U.S. companies by eliminating major tax and trade inequities in the treatment of U.S. companies conducting business abroad.

On behalf of its member companies, the NFTC has been quite active in efforts to pursue a legislative solution in California that satisfies both the revenue concerns of

the State of California and avoids retaliation by the UK and other foreign governments against U.S. business interests operating in their countries. Many member companies of the NFTC have a substantial presence in California and also in the UK and in other foreign countries.

As you are aware, the UK has threatened to retaliate by denying the refund (ACT) available to U.S. companies under the existing UK-U.S. Income Tax Treaty unless California adopts legislation by the end of this year to repeal the mandated use of the worldwide unitary Method for UK companies conducting business in California. Similar complaints have been lodged against the unitary method by other EC countries, including Germany and the Netherlands.

The overriding objective of the NFTC is to press for enactment of legislation in California prior to the date of adjournment this year which meets California's revenue requirements and satisfies the concerns of the UK to avoid retaliation against U.S. business interests. (Emphasis supplied)

The NFTC offers the following comments and suggests modifications to S.B. 671 in order to satisfy the concerns of the UK and other foreign governments and also to provide a fair taxing regime in California for both U.S. and foreign multinational companies.

1. *Waiver of election Fee.* The fee imposed under present law to elect the water's edge method for filing should be repealed. We believe that inclusion of this recommendation in legislation is essential to avoid UK retaliation.

2. *The election of a water's edge method should be irrevocable.* The ability of multinational companies, both foreign and domestic, to elect use of the water's edge method for filing must be irrevocable. If the authority of the Franchise Tax Board officials to revoke the water's edge election under present law is retained, it is quite certain that the UK will retaliate against U.S. interests.

3. *The domestic spreadsheet should not be required.* The domestic spreadsheet requirement should be deleted. The compliance costs to companies of providing this information vastly exceeds any audit advantage to California taxing authorities. The NFTC and its membership can support the alternative suggestion of the Franchise Tax Board that a list of 20 percent or more owned affiliated corporations could be provided by companies with a minimum of one billion dollars in assets.

While the NFTC has other modifications that it could suggest to improve the tax system for multinational companies, both foreign and domestic, in California, the compelling need for enactment of legislation by the date of adjournment to avoid UK retaliation dictates that other recommended changes must be deferred for consideration until a later date. Adoption of legislation by California that includes the items recommended above should satisfy UK concerns and avoid a destructive tax war between the U.S. and its major trading partners that would undermine the investment climate in both countries.

The NFTC commends you and your colleagues in the California legislature for your efforts to seek a solution to this troublesome problem. The NFTC recognizes that any

solution must carefully balance the interests of the State of California and its need for revenue neutrality against the potential losses to be suffered by U.S. businesses operating abroad if countries, such as the UK, act upon their threatened retaliation at the end of this year.

We would be pleased to respond to any questions that you may have.

Very truly yours,

/s/ Frank D. Kittredge
Frank D. Kittredge
President

SENATE THIRD READING

SB 671 (Alquist) – As Amended: September 9, 1993

SENATE VOTE: 26-8

ASSEMBLY ACTIONS:

COMMITTEE REV. &. TAX VOTE 6-0

COMMITTEE W. & M. VOTE 14-7

Ayes: Horcher, Allen, Costa, Epple, Johnson, Brulte, Lee, Murray, Nolan, O'Connell, Polanco, Quackenbush, Seastrand, Woodruff

Nays: Vasconcellos, Alpert, V. Brown, Burton, Campbell, B. Friedman, Hannigan

DIGEST

Existing law provides for the apportionment of income for firms doing business both within California and outside the state, for deductions against income of certain meals and entertainment expenses, a credit for certain research and development activities, a sales and use tax on the purchase of manufacturing equipment, and various other provisions.

Existing law, income apportionment, provides that for corporations which operate both within California and in other states or nations, the portion of the firm's total income attributable to California is determined by a "three-factor" formula relating the company's payroll, property and sales in California to the total of those factors nationwide or worldwide.

However, a company can make a "water's-edge" election. Under this method, a firm can compute its California

taxable income by reference to its income and apportionment factors from within the "water's-edge" only, rather than worldwide. Essentially, this means foreign business operations are excluded from the calculation.

There are various requirements for companies making the water's-edge election, and the Franchise Tax Board (FTB) has certain authority to enforce these provisions. Specifically, the water's-edge legislation required a firm making the election to: 1) pay an election fee; 2) file a "domestic disclosure spreadsheet" every three years if the firm had property, payroll or sales which exceeded specified amounts; and 3) allow FTB to "disregard" a company's water's-edge election of the FTB determined that the taxpayer willfully refused to provide specified audit information.

This bill:

1) *Income Apportionment.* Makes various changes to California's unitary method of income apportionment, including:

    a) Deletes the requirement to file the domestic disclosure spreadsheet for firms making the water's-edge election, and replaces this requirement with a minimal reporting requirement for firms with over $200 million in assets.

    b) Eliminates FTB's authority to "disregard" a water's-edge election. In place of the disregard authority, the bill requires taxpayers to provide specified audit information. Taxpayers failing to provide that information would be subject to a substantial penalty (in lieu of the current disregard power).

    c) Repeals the election fee for taxpayers filing their return on a water's-edge basis. The repeal is effective for income years beginning on or after January 1, 1994.

2) *Business Meals.* Reduces from 80% to 50% the percentage of business meals and entertainment which may be deducted as an ordinary and necessary expense. This change is consistent with recent federal tax law changes.

3) *Subchapter S.* Reduces from 2.5% to 1.5% the tax rate applied to Subchapter S corporations.

4) *Investment Tax Credit.* Establishes a tax credit equal to 6% of qualified manufacturing equipment placed in service after January 1, 1994. However, the credit could not be claimed prior to a taxpayer's 1995 tax year.

    The credit could only be claimed for manufacturing equipment which is "depreciable" under certain federal tax rules. Additionally, "special purpose buildings and foundations" for certain electronic manufacturers would be eligible for the credit, as would property related to specified biotech engineering activity.

    The credit could be claimed against both the regular tax and the alternative minimum tax, and unused credits could be carried forward for up to 8 years (10 years for "small" firms).

    The credit would sunset January 1, 2001 if manufacturing employment in California (except aerospace employment) does not increase by at least 100,000 between January 1, 1994 and January 1, 2001.

    Additionally, the measure allows a "start-up" firm the option of a 5% sales tax exemption on qualifying manufacturing equipment during its first 3 years of

operation (e.g., a start-up firm could take either the 6% income tax credit or the 5% sales tax exemption). A start-up firm is defined as a firm which begins business after January 1, 1994.

5) *Space Flight Material.* Exempts from the sales and use tax space flight material used in a launch originating at Vandenberg Air Force Base. This exemption sunsets January 1, 2004.

6) *Research and Development Credit.* Deletes the January 1, 1998 sunset date of the research and development tax credit, thereby making the credit permanent. Additionally, the measure replaces the state's "three-year rolling average" method of calculating the credit with the federal "fixed base" method.

7) *Small Business Stock Capital Gains.* Exempts from taxation 50% of the capital gain realized from the sale of a qualified small business stock held for 5 or more years. For a stock to be eligible for this income exclusion, it must meet the following criteria:

   a) Must be originally issued after August 10, 1993 and before December 31, 1998, by a company doing business in California which has less than $50 million in gross assets. At least 80% of the qualifying company's payroll must be attributable to employment located in California.

   b) The issuing company cannot be engaged primarily in the performance of specified services including: health, law, engineering, accounting, performing arts, or consulting. Additionally, firms engaged in banking, insurance, farming, oil and gas extraction, or hotels and restaurants cannot issue qualifying stock.

   These criteria are consistent with recent federal tax changes which create a similar capital gains exemption.

FISCAL EFFECT

State: The net effect of estimates provided by FTB, the Board of Equalization and the Governor's office is that this measure would generate revenue losses of approximately $27 million in 1993-94, $92 to $142 million in 1994-95, $368 to $418 million in 1995-96, and $375 to $425 million in 1996-97. The effect of the individual provisions of the bill are summarized in Attachment I.

Local: Annual revenue losses in the range of $1 million due to the bill's exemption for space flight material.

Attachment I

SB 671 (Alquist) Summary of Fiscal Effect

($ in millions)

	1993-94	1994-95	1995-96	1996-97
Repeal Water's-Edge Election Fee	$-15	$-60	$-75	$-80
Research & Development Tax Credit	-22	-45	-50	-60*
Small Business Stock Capital Gains Exemption	---	---	---	---**
6% Investment Tax Credit	---	-50 to -100	-300 to -350	-300 to -350
Reduce Business Meals Deduction	+40	+140	+150	+160
Sales Tax Exemption for Space Flight Property	---	-7	-15	-15
Reduce Subchapter S Tax Rate	-30	-70	-78	-80
Net Fiscal Effect	-27	-92 to -142	-368 to -418	-375 to -425

* Deletion of sunset will increase this loss beginning in 1998-99 by about $150 million and by increasing amounts annually thereafter.

** Revenue losses from capital gains exclusion do not begin until 1998-99 and are in the range of $15 million, increasing to $43 million by 2001-02.

Source: Franchise Tax Board, Board of Equalization, Governor's Office

(46) (26)

Nos. 92-1384 and 92-1839

In The

Supreme Court of the United States

October Term, 1993

BARCLAYS BANK PLC,
Petitioner,
vs.
FRANCHISE TAX BOARD,
An Agency of the State of California,
Respondent.

COLGATE-PALMOLIVE COMPANY,
Petitioner,
vs.
FRANCHISE TAX BOARD,
An Agency of the State of California,
Respondent.

On Writs of Certiorari to the Court of Appeal of the State of California in and for the Third Appellate District

---

BRIEF OF AMICI CURIAE IN SUPPORT OF RESPONDENT FRANCHISE TAX BOARD BY SENATORS BYRON L. DORGAN, TED STEVENS, FRANK H. MURKOWSKI, JUDD GREGG, AND ROBERT C. SMITH

Charles Rothwell Nesson
1575 Massachusetts Avenue
Cambridge, MA 02138
(617) 495-4609
Counsel of Record

14 P

QUESTION PRESENTED

When the United States Senate has carefully studied and unambiguously rejected a treaty provision that would bar the States from employing a particular method of corporate tax accounting for foreign corporations, should the Judiciary nevertheless prevent a State from using this method of accounting under the dormant authority of the Foreign Commerce Clause?

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TABLE OF AUTHORITIES

Nos. 92-1384 and 92-1839

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INTEREST OF AMICI

Amici are members of the United States Senate. This case presents this Court with issues involving the proper roles of

the Executive Branch and the Senate in establishing United States policy through the treaty mechanism. Amici, as members of the United States Senate, have a unique and vital interest in these questions and, in particular, the significance to be attached to the actions of the United States Senate in declining to give its advice and consent to a treaty presented to it by the Executive Branch, as required for ratification by the Constitution of the United States.

STATEMENT PURSUANT TO RULE 37

This brief is submitted pursuant to Rule 37.3 of this Court in support of Respondent Franchise Tax Board, State of California. The consent of counsel to the filing of this brief has been obtained and has been or will be filed with the Clerk of this Court in due course.

SUMMARY OF ARGUMENT

The United States Senate was asked to give its advice and consent to a tax treaty between the United States and the United Kingdom which would have prohibited the States from using the unitary method of tax accounting with respect to multinational businesses domiciled in the United Kingdom. After intensive consideration, the Senate refused to give its advice and consent to the Treaty with this prohibition. This refusal was made in fulfillment of the Senate's constitutional role as a protector of State sovereignty. With all due respect and deference to the wisdom which this Court possesses and exhibits, it is respectfully submitted that this Court should not intervene in this matter so as to overrule the judgment made by members of the Senate.

ARGUMENT

THE SENATE'S REFUSAL TO CONSENT TO A TREATY IS AN ACT OF CONSTITUTIONAL SIGNIFICANCE

The cause here is the right of States of the United States to choose the mode of tax accounting to be used in the raising of state revenue. At issue also is the constitutional integrity of the United States Senate.

The unitary method of tax accounting is an integrated, conceptually fair basis of taxation which seeks to negate the intense complexities of intercorporate international tax accounting embodied in the "arm's-length" method. The arm's-length method treats each legal corporate entity as if it were real, while ignoring the identity of the whole enterprise. The unitary method identifies the income of the whole and then apportions that income according to the proportionate contribution of the taxing State.

The constitutional integrity of the United States Senate is at stake because of the risk that the Supreme Court of the United States will ignore the Senate's constitutionally given power to play a role in the balance to be cast between state and local power on the one hand and foreign policy on the other.[1] The Constitution empowers the Senate, as part of the

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[1] In prior decisions, this Court has exhibited its sensitivity to the Senate's role in our federal structure. For example, in *Garcia v. San Antonio Metropolitan Transit Authority*, 469 U.S. 528 (1985) at 551-552, this Court stated:

> The extent to which the structure of the Federal Government itself was relied on to insulate the interests of the States is evident in the

(continued...)

Congress, to regulate commerce, interstate and foreign, and to advise and consent in the m-'..ng of treaties of agreement with foreign nations.

In the circumstances of the present case, the Executive Branch sought the advice and consent of the Senate to a treaty negotiated with Great Britain about terms of trade. High in priority among the provisions sought by Great Britain was agreement by the United States to impose a ban upon States from using unitary methods of tax accounting. The treaty would have imposed the "arm's-length" method on all of the States of the United States by the constitutional supremacy of treaties over domestic law.[2] Great Britain, in these

[1](...continued)
views of the Framers. James Madison explained that the Federal Government "will partake sufficiently of the spirit [of the States], to be disinclined to invade the rights of the individual States, or the prerogatives of their governments." [citation omitted] . . . "it was a favorite object in the Convention" to provide for the security of the States against federal encroachment and that the structure of the Federal Government itself served that end. [citation omitted] . . . equal representation of the States in the Senate, which he saw as "at once a constitutional recognition of the portion of sovereignty remaining in the individual States, and an instrument for preserving that residuary sovereignty." [citation omitted] . . . "the residuary sovereignty of the States [is] implied *and secured* by that principle of representation in one branch of the [federal] legislature" (emphasis added). [citations omitted] . . . the Framers chose to rely on a federal system in which special restraints on federal power over the States inhered principally in the workings of the National Government itself, rather than in discrete limitations on the objects of federal authority. State sovereign interests, then, are more properly protected by procedural safeguards inherent in the structure of the federal system than by judicially created limitations on federal power.

[2] U.S. Const., art. VI, § 2.

negotiations, may be seen as speaking for the international multinational corporate and banking interests that want to take advantage of United States markets and natural resources without having to account for any of the benefits which flow between local activities and the rest of their global enterprises.

The Senate intensely considered the request of the Executive Branch for its advice and consent to this treaty.[3] The Senate responded, rejecting the treaty as written, consenting to its ratification only without the ban on the use by the States of the unitary method of accounting.[4] The Senate continued to attend to the issue intensively until the problem was significantly resolved through political channels in the mid-1980's.[5]

[3] 124 Cong. Rec. 18402-18430, 18651-18670 (1978).

[4] 124 Cong. Rec. 18670, 18709-18712 and 19076-19078 (1978).

[5] Various committees of the United States Congress have held hearings on the issues of state taxation including the use by the states of unitary reporting. The hearings listed below indicate the intensity, both in depth and time of consideration:

> Report of the Subcommittee on State Taxation of Interstate Commerce of Committee on Finance on S. 1245 (Mathias) and S. 2092 (Magnuson) (490 pages); Committee on Ways and Means, 95th Congress, 1st Sess., Recommendations of the Task Force on Foreign Source Income (Comm. Print 1977); Senate Committee on Foreign Relations, Third Protocol to the 1975 Income Tax Convention with the United Kingdom of Great Britain and Northern Ireland as Amended, S. Doc. No. 5, 96th Cong., 1st Sess. (1979) (150 pages); Tax Treaties with the United Kingdom, the Republic of Korea, and the Republic of the Philippines, 1977: Hearings Before the Senate Committee on Foreign Relations, 96th Cong., 1st Sess. (1977) (496 pages); State Taxation of Interstate Commerce and Worldwide Corporate Income, 1980: Hearings on S. 983 and S. 1688 Before the Subcomm. on Taxation and Debt Management Generally of the Senate
> (continued...)

Now the multinational corporate interests try a different tack, here direct to the United States Supreme Court for a ruling from the Justices that unitary approaches to taxation should be banned under the authority of the Foreign Commerce Clause where multinational corporations are concerned. The premise of Petitioners' claim is that Congress has not spoken on the issue of a ban on States wishing to use other than arm's-length accounting, that the Federal Government must speak on this issue with "one voice," and therefore the Judiciary should dictate the arm's-length method under the dormant authority of the Foreign Commerce Clause. But to say, in this situation, either that the Congress has not expressed itself or that the situation requires one and only one approach, blinks reality.[6] Because the Senate has spoken in its constitutional voice,[7] the California tax is permissible.

To grant the petitioners' request would constitute an institutional insult to the Senate. The Executive Branch invoked Senatorial process, and does not assert the inconsequence of resulting Senatorial action. Since the Senate's rejection of the ban, the Executive has repeatedly

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[5](...continued)
Comm. on Finance, 96th Cong., 2d Sess. (1980) (982 pages); Unitary Taxation, 1984: Hearings Before the Subcomm. on International Economic Policy of the Senate Foreign Relations Comm., 98th Cong., 2d Sess. (1984) (445 pages); Interstate Taxation, S. 2173: Hearings Before the Senate Committee on the Judiciary, 95th Cong., 1st and 2d Sess. (1977-1978) (957 pages).

[6] *Wardair Canada v. Florida Dept. of Revenue*, 477 U.S. 1, 11-12 (1986), establishes that rejection of treaty provisions can have legal significance for Foreign Commerce Clause analysis.

[7] U.S. Const., art. II, § 2, cl. 2.

recognized the Senate's position and has made no effort to circumvent it. Instead, conflicts over tax accounting methods have been further negotiated through diplomatic and political processes.[8] California changed its law substantially in 1986,[9]

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[8] The Executive Branch negotiated the United States/United Kingdom Tax Convention with the United Kingdom in 1975. In transmitting the proposed treaty to the Senate for its advice and consent, the Executive Branch noted, "A second new provision is found in paragraph 4 of Article 9 (Associated Enterprises). This provision represents the *first attempt* to bind State and local taxing authorities by a substantive provision of the treaty (other than non-discrimination)." (Emphasis added). Letter of Submittal, June 8, 1976, 3 Tax Treaties Reporter (CCH) ¶ 10,938. The Executive Branch then negotiated the Third Protocol to the Treaty to reflect the action of the Senate. In a summary of the Protocol prepared for the Senate Foreign Relations Committee, the first modification is described by the Executive Branch as follows:

> "In conformity with the Church reservation, the protocol makes Article 9(4) of the proposed treaty, which restricts the use of the worldwide combination/unitary method of apportioning income, inapplicable to state or local governments. The provisions of Article 9(4) would continue to apply, however, to the United States and United Kingdom governments." Third Protocol to the 1975 Income Tax Convention with the United Kingdom of Great Britain and Northern Ireland, as Amended: Report of the Committee on Foreign Relations, United States Senate; S. Doc No. 5, 96th Congress, 1st Sess. (1979)

In 1979 in response to a question by Senator Church, Assistant Secretary of Treasury for Tax Policy, Donald C. Lubick, submitted the following explanation to the Committee on Foreign Relations of the United States Senate as to why state taxes were not included by the administration in its own Model Income Tax Treaty:

> "These local U.S. taxes are not covered because it is unlikely that the United States would consent to the ratification of any treaty provision that restricted the rights of the various states to impose their own taxes." *International Tax Treaties: Hearing before the Senate Comm. on Foreign Relations*, 96th Cong., 1st Sess. (June 6, 1979), p. 112 (statement of Donald C. Lubick).

(continued...)

with refinements in 1993,[10] which led the Executive Branch, through the Solicitor General, to suggest to this Court the wisdom of declining to hear the present case and refraining

[8](...continued)

During consideration of the proposed Unitary Tax Repealer Act in 1985, Roger Mentz, Assistant Secretary of the Treasury for Tax Policy, testified for the Executive Branch as follows:

> "I am pleased to report that, since the introduction of the legislation, Idaho, New Hampshire, Utah, and, on September 5, California, have enacted "water's edge" legislation. The Administration applauds these states' actions. These state legislative developments go a long way toward resolving the difficult unitary tax issue. Moreover, they illustrate the *successful* operation of the Federal system. . . . We have not . . . reached the end of the road with respect to this issue. . . . *We believe, however, that such significant progress has been made that restrictive Federal legislation is not warranted at this time.*" *Review of Unitary Method of Taxation: Hearing Before the Subcommittee of Finance on Taxation and Debt Management of the Committee on Finance on S. 1113 and S. 1974*, 99th Cong., 2d Sess. (September 29, 1986), p. 71. (Emphasis added).

In transmitting the 1973 Income Tax Convention with the Union of Soviet Socialist Republics to the Senate Foreign Relations Committee, the State Department made the following statement regarding "Taxes Covered" in the Technical Explanation: "The taxes imposed by the Union Republics of the Soviet Union (comparable to states of the United States) are not covered by the Convention because, *in keeping with past U.S. policy the taxes of the state and local governments of the United States* are excluded from the scope of the Convention, except for purposes of Article X (Nondiscrimination)." (Emphasis added). 3 Tax Treaties Reporter (CCH) ¶ 10,630 p. 44,029.

[9] Ch. 660, Cal. Stats. 1986.

[10] Ch. 881, Cal. Stats. 1991.

from taking a position in support of Petitioners on the merits.[11]

We in the Senate do not understand the Supreme Court of the United States to have been anything but sensitive in the past to the balance and separation of powers among the Federal branches and the States in respect to judicial interpretation of the Foreign Commerce Clause. The Supreme Court's opinion in *Container Corp. of America v. Franchise Tax Bd.*, 463 U.S. 159 (1983), sets the framework with a remarkably direct and able dissection of the foreign commerce problem, holding that California had no obligation under the Foreign Commerce Clause to employ the "arm's-length" method, as long as application of its unitary approach is fair.

Yet it is incumbent upon us, not as supplicants only before a great court, but as friends of the court asserting equal stature for the institution of the Senate and equal strength in the balance of the power of our Nation, to say that the Federal Government does not speak, need not speak, and should not be made to speak with the "one voice" to impose the "arm's-length" method of taxation upon the separate States.

We assert the constitutional entitlement of the United States Senate to a role of principal in the making of international treaty arrangements. We ask the Supreme Court

[11] Brief of United States, October 7, 1993, *Barclays Bank PLC v. Franchise Tax Board*, p. 10-11.

of the United States not to allow our role and process to be ignored and overridden.

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